

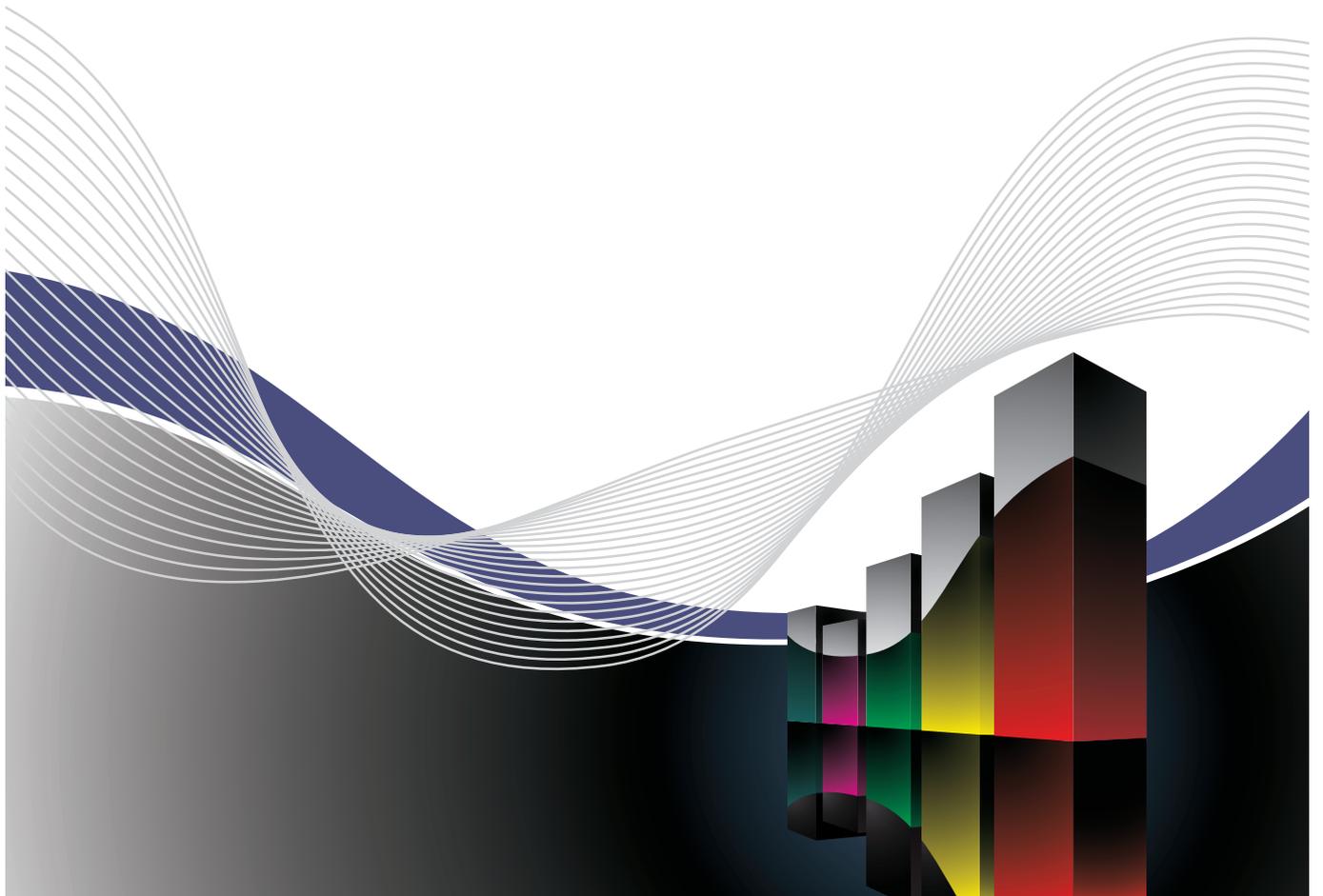
**THE ROYAL SOCIETY OF EDINBURGH
SCOTTISH FINANCIAL ENTERPRISE
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SCOTLAND**

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SCOTTISH FINANCIAL ENTERPRISE

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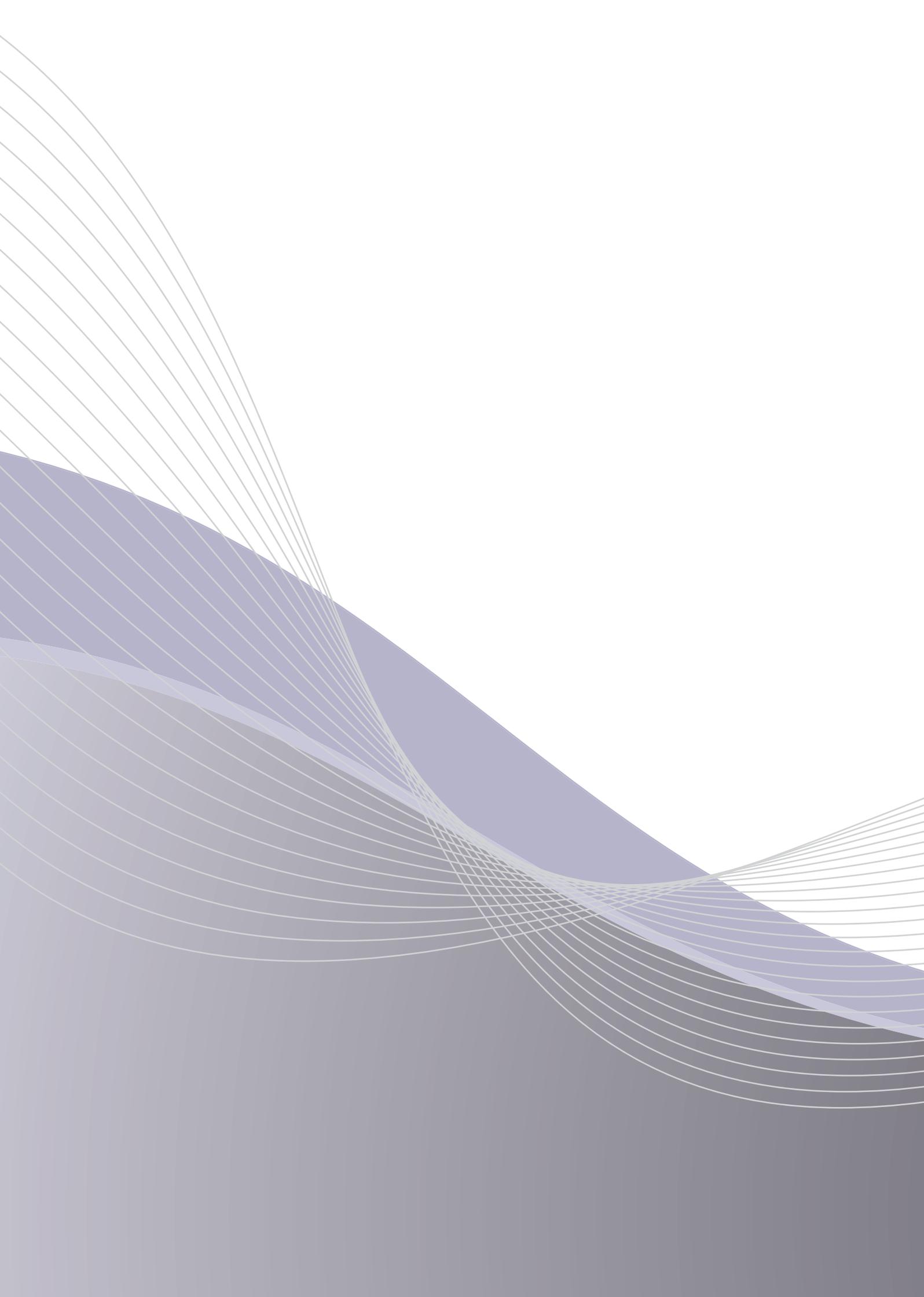
ICAS



Joint Working Group Report

The Supply of Growth Capital for Emerging High-Potential Companies in Scotland

June 2014



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Executive Summary

Introduction

The Working Group was established in mid-2013 to consider the performance of the market in Scotland for capital investment targeted at emerging companies of high potential. The Group was convened under the joint auspices of the Royal Society of Edinburgh (RSE), Scottish Financial Enterprise (SFE) and the Institute of Chartered Accountants of Scotland (ICAS). Its work follows on from the RSE Advice Paper “*The Financing of Business Innovation in Scotland*”, published in October 2012. The membership of the Group is set out in **Annex 1**.

In the context of the Working Group’s discussions, the term “emerging companies” has been used to refer to companies that have reached a stage of maturity at which their requirements for capital to finance further growth are substantial, i.e. beyond the startup and seed level that is relatively accessible from sources currently existing within Scotland. The focus has been on development capital required to enable successful small companies to continue to build on their existing achievements and grow into businesses of nationally- and internationally-significant scale.

The Scottish environment

Scotland is well served in terms of access to seed capital, notably from its strong business angel community supported by public sector co-investment from the Scottish Investment Bank (SIB). Increasing organisation of the business angel community, together with the impact of SIB activity, has over the last decade increased the overall amount of investment available from this quarter. This infrastructure has been a major factor in stimulating and supporting the creation of new companies, and many young businesses now active in Scotland owe their existence to it.

Whilst the venture capital (VC) sector in Scotland is fairly small, it includes a number of notably successful players, and a few Scottish VC firms have managed to raise new funds in the challenging climate of the past few years. Most look more widely than Scotland for investment opportunities, although there have been significant investments into Scottish companies by local VC funds. The investment criteria and model applied by VC funds usually differ materially from those applied by business angels, and the two generally find it difficult to work together.

As in the rest of the UK, the relationships between commercial banks and smaller companies have changed fundamentally since the financial crisis of 2008. Banking regulations have introduced more stringent risk criteria for lending. In many cases, these have reduced access for small companies to conventional overdraft or term lending arrangements, limiting the options to debtor or lease finance arrangements where these are viable. This has had a significant effect on the capitalisation of early-stage companies. Whereas ten years ago many could be financed by equity and debt in roughly equal proportions, the bank lending element has diminished for companies without asset backing or external guarantees. Growth aspirations have increasingly had to be funded from other sources; in many cases equity investment.

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The business angel community does not have the capacity regularly to make investments at the multi-million pound level required to fund growth beyond the seed and early stages, and VC investment is relevant and appropriate to only a tiny proportion of companies. There are signs that the so-called “funding escalator” is struggling:

- A graduation from angel to venture capital investment is not a natural or straightforward progression. As noted above, the motivations and criteria that drive angel investment differ significantly from those that drive VC investment, and the two tend not to co-exist comfortably.
- Angel syndicates have increasingly been called upon to support existing portfolio companies with follow-on funding, rather than making new investments, as conventional sources of working capital have dried up. As a consequence, less capital is available for startups.
- Exits for early stage investors have become slower (ten years from first investment is now typical), limiting capacity for recycling of investment into new opportunities.

The transition from early-stage to mid-stage growth depends on access to substantial financial resources, and appropriate corporate finance advice has an important role to play. Finance is not, however, the only consideration – there is likely to be a need for a considerable strengthening of management capability and a shift in mindset, as a transition from an “entrepreneurial” to a “corporate” organisation begins to take place. These changes of themselves represent significant challenges. The fundamental level of ambition driving the business is a critical factor and may, to a significant extent, be conditioned by its immediate environment. This consideration, particularly as it relates to constraints on access to growth finance, has been a major influence on the Working Group’s deliberations. Its primary objective has been to identify steps that might be taken to mobilise greater amounts of funding from private sector sources for investment in Scotland’s most promising emerging companies.

The supply of investment

Scotland has for centuries had an important and internationally significant financial services industry. It is home to a range of institutional investment and fund management organisations, including some of the most prominent names in the sector, which between them have funds under management of the order of £750 billion. In terms of their employment and earnings, these organisations make a major contribution to the Scottish economy.

There is, therefore, a certain irony in identifying access to investment as a constraint on the growth and development of Scottish non-financial companies. There does, however, appear to be very limited interaction, direct or indirect, between institutional investors and the non-financial corporate base – in particular, companies of the type and stage of maturity discussed above. The amount of money under management by institutions in Scotland that finds its way into investment in emerging high-potential Scottish companies is relatively tiny.

There are various reasons why this is the case. For example:

- Institutional investors are bound by fiduciary duties to the owners of the funds under their management, and often operate within tight constraints in terms of allocation across asset classes, geographies, etc.
- There is a mismatch of scale between institutional investors and small companies – the institutions' lower economically-viable limits of investment size are typically far in excess of the sums relevant to any individual small company, or even to a small venture fund.
- Investment in smaller unquoted companies (even those which would be seen by business angels as substantially de-risked) is perceived by institutions as very high risk.
- This perception is probably reinforced by institutions' experience over the past decade or so of investment in venture capital funds, which has in general yielded poor returns.

There is no scope for local sentiment in any discussion of allocation of resources by institutional investors. For example, the fundamental responsibility of Scottish pension funds is to meet the pension payments due to their members as these fall due. Whilst their trustees might, all other things being equal, be inclined to favour investments that would stimulate economic development in Scotland, they would consider doing so only if the risk/return profile and other parameters met their specific and demanding criteria.

It follows that any initiative to mobilise institutional money in this context must make the case that small unquoted companies can represent compelling investment opportunities, that this asset class is at present largely being overlooked by institutional investors, and that the associated risks can in fact be managed or mitigated.

Broadly similar arguments apply to the stimulation of investment by individuals through retail channels. It seems possible that there may be a considerable number of people who do not have the inclination, or perhaps the opportunity, to engage in business angel investment in the conventional sense, but who would nonetheless be interested in the possibility of investing in small unquoted companies. The Venture Capital Trust (VCT) mechanism offers tax incentives to individuals for investment of this type, as well as enabling investment amounts below the usual angel range to be spread across a number of companies.

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Recommendations

The primary recommendations of the Working Group are as follows:

VENTURE FUND ATTRACTIVE TO PENSION FUND INVESTORS

The managers of pension funds face significant challenges in generating the level and type of returns they require. There is scope for investment of considerable sums in emerging companies with substantial growth potential. The conventional intermediary mechanisms between these two constituencies do not currently appear to be functioning very effectively. This raises for consideration the feasibility of designing a venture fund structure that might be more successful in attracting pension funds to invest.

The UK Government's Enterprise Capital Funds model has used public sector funding as a cornerstone to attract private sector co-investment into relatively small venture funds. This model, in which the returns on the public sector element carry a preference but are limited, has evidently been successful. Pension funds might see some attraction in a similar approach, offering a relatively modest but secure return, rather than the more extreme risk/return profile of the conventional VC model. The feasibility of designing such a structure to operate comfortably as a follow-on from business angel investment would add another dimension to the challenge.

An initiative of this type would, by its nature, have to be rooted in the private sector. However, carefully designed and targeted public sector support might play a catalytic role in stimulating the private sector to investigate the feasibility of establishing a vehicle of this type, and possibly to some extent in adjusting the risk/return profile to align with the requirements of pension fund investors.

SUPER CO-FUND

The model involving co-investment of public sector with business angel money was first developed by the Scottish Co-Investment Fund (SCF) in 2003. A concept suggested as worthy of consideration would be the addition to this structure of a further tier drawing on institutional investment. In principle, a "Super Co-fund" might invite institutional investors to match the combined seed (usually angel) plus public sector co-investment at some appropriate ratio, which would be the subject of consultation between all the parties involved.

Used appropriately, this structure would enable institutions to invest alongside successful business angel syndicates in companies that had progressed beyond seed stage and had achieved at least initial market penetration. From the business angel perspective, therefore, these companies would have been substantially de-risked, although by the standards of institutional investors they would still be regarded as very high risk. Institutions might, however, be attracted by clear evidence of superior (if long-term) business angel returns and a lean low-cost management structure.

An accredited lead partner approach, similar to the principle underlying SCF, could contain costs to a level below that of a conventional VC fund. A structure of this type would need to win the confidence of institutional investors, and also be capable of achieving an acceptable spread of risk at the scale required to be viable for them. The feasibility of meeting these criteria would need to be the subject of careful consideration and investigation.

USE OF VENTURE CAPITAL TRUST VEHICLES

There could be scope for re-visiting the use of Venture Capital Trust (VCT) structures operating from a base in Scotland to attract additional retail investment into the emerging company market. This is not a new concept, and the suggestion arguably runs counter to the recent trend for VCT offices to move away from Scotland.

Relatively high management fees are sometimes cited as a disincentive to investing in VCTs. Any viable approach to reducing costs would, therefore, be worth examining. For example, a co-investment model partnering with successful business angel syndicates might enable a VCT to operate with a relatively “light-touch” management infrastructure, as far as would be compatible with maintaining good governance and regulatory compliance. It might rely to a large extent on its accredited partners for due diligence, negotiation of investment terms and oversight of portfolio companies.

At least one example of a symbiotic relationship between a VCT and business angels is known to exist in the UK. It is suggested that this and any other possible similar approaches should be investigated and evaluated further.

ACCESS TO CORPORATE FINANCE ADVICE

The availability of high-quality corporate finance advice is, as noted above, an important element of the environment to support high-potential companies. This is relevant from the startup stage, to try to ensure that all funding possibilities are considered and that early decisions do not constrain future options. Consideration should be given to ways in which such advice could be made available to early-stage companies at realistic cost.

INFRASTRUCTURE TO ENGAGE WITH INVESTORS OUTSIDE SCOTLAND

The most relevant sources of investment for many companies may lie outside Scotland. Consideration should be given to strengthening the infrastructure available to support Scottish companies in researching and addressing international investment markets.

1.0 Context and Challenge

The capacity of the Scottish economy to create and retain indigenous companies of internationally significant scale and scope has been the subject of debate over many years. The inexorable internationalisation of business across the globe has seen the acquisition of a succession of Scottish-headquartered public companies by multinational buyers. This trend is not unique to Scotland, but has been experienced across UK regions. Analysis by the accountancy firm PwC in 2010 indicated that the proportion of FTSE 350 companies based in the UK regions (i.e. outside London) fell from 51% to 42% between 2000 and 2009.¹

It was reported in February 2012 that the number of Scottish companies listed on the London Stock Exchange (both main market and AIM) had fallen from 80 in October 2007 to 58 in November 2011². It could, of course, be argued that this decrease was at least in part attributable to the economic background during the period. There remains, however, a concern on the part of some commentators over the migration away from Scotland of the ultimate strategic decision-making and headquarters functions of a significant proportion of the country's larger businesses.

The importance of this migration of control is sometimes questioned. It does not, after all, necessarily equate to a loss of local operational functions, employment or multiplier effects generated by the Scottish-based operations of companies acquired by external purchasers. It can lead to an injection of new thinking and access to the resources and market channels available through a larger and more diverse organisation. It could, therefore, be argued that concerns over such acquisitions are rooted more in sentiment or national pride than in any real economic rationale.

Acquisition by a non-indigenous entity of a substantial locally-headquartered company is, however, likely to have significant impacts on the business involved, on the people who work for it and ultimately on the local business environment. Considerations include:

- Loss of strategic control – after acquisition, the future direction, diversification, market relationships and growth of the business will be determined by the context and priorities of a larger organisation, with the inevitable possibility of constraints on freedom to operate and allocation of resources.
- Acquisition is likely to lead to some degree of centralisation of key management functions, particularly in areas such as business strategy, planning, corporate finance and corporate governance. Relocation of these responsibilities may mean that, whilst senior levels of operational management continue to be based in Scotland, their mindset may change somewhat. There is a difference between managing a branch operation of a multinational and being (and feeling) close to the centre of the highest level of decision making and control of a business.
- Supply chain impacts. Acquisition may impact on relationships between the company and suppliers. Local supply relationships may be displaced by the purchasing practices of the acquirer. This may be particularly likely in areas relevant to the headquarters function – for example, professional and support services in areas including finance, legal, marketing, public relations, etc.

¹ “North suffers from the pull south”; *Financial Times* 17 Feb 2010

² “Steep fall in the number of listed Scottish companies”; *Sunday Herald* 12 Feb 2012

Context and Challenge

All of these factors have an influence on the overall business “ecosystem” in Scotland – on the people who operate within it, on the breadth and depth of experience available to it and on its level of ambition and self-confidence.

It is suggested, therefore:

- i) that the existence of indigenous businesses of significant scale is an important factor in the health of an economy;
- ii) that the capacity for acquisition of indigenous businesses by foreign buyers is an inherent characteristic of an open economy in a globalised environment.

Taken together, these two observations inevitably direct attention towards the process of evolution and development of new generations of emerging companies with the potential to grow to augment the population of nationally- and internationally-significant indigenous businesses. It has been suggested on a fairly regular basis by a variety of commentators that this process in Scotland appears to be less dynamic and effective than it might be, and concerns have periodically been expressed over a perceived “hollowing out” of the Scottish business base. The funding infrastructure available to growing companies, the apparent disconnects in the so-called “funding escalator” and the tendency for promising Scottish companies to be sold at an early stage were discussed in an RSE Advice Paper published in 2012.³ The paper suggested that, “To use an analogy, we have an environment that is well adapted to growing seedlings into pot plants for early sale; it is not well adapted to growing bushes, far less trees”.

Debates around this topic can take on emotive overtones, perhaps reflective of individual experience and viewpoints or specific constituency interests. Commentators may question whether observed trends are due to cyclical conditions or to structural factors, or who may be responsible for perceived shortcomings in the Scottish business environment.

This report does not set out to do any of these things. Rather, it simply works from the premise that the Scottish economy would be likely to benefit in the long term from an environment in which more Scottish companies are enabled to realise more fully their potential as independent enterprises.

3 “The Financing of Business Innovation in Scotland”; RSE Advice Paper 12-10; October 2012

2.0 Sources of Capital

2.1 Introduction

The primary focus of the Working Group has been the achievement of more effective mobilisation of capital from private sector sources into investment in emerging growth companies. Its objective has been to consider the overall investment environment with a view to identifying possible approaches to establishing more effective and productive linkages between:

- i) private sector sources of capital
and
- ii) companies which have demonstrably high growth potential but whose capital requirements are not currently well served (for example, because their requirements are beyond the capacity of readily-addressable existing sources of investment or because the nature of their activities and business model does not fit well with the criteria applied by existing sources of investment).

In this context, the appropriate role of public funding has been regarded as catalytic rather than central. It might, for example, have a role in meeting certain “pump priming” or similar costs or in achieving adjustments in risk/reward dynamics to encourage the mobilisation of private sector resources, but it has not been viewed as a core element of flows of funding of the types which the Working Group has considered.

The starting point for the Group was therefore the identification and characterisation of private sector sources which might reasonably be regarded as potential providers of growth capital for investment in emerging companies.

The sources of capital considered by the Group are discussed below.

2.2 Institutional Investors

2.2.1 Pension Funds

One of the key challenges in managing investment of most types and in most contexts is balancing spread of risk against cost of management. For example, an individual investing in quoted companies may regard the minimum economic single shareholding value as being a few thousand pounds (determined largely by dealing costs). For a small venture capital fund, it may be around two million pounds (determined by the basic irreducible cost of managing an investment, whatever its size, in a single company).

In this context, one of the defining characteristics of pension funds is their sheer size. The most recently available annual survey undertaken by industry representative body the Investment Management Association (IMA) estimated that pension fund assets accounted for approximately £1.3 trillion, or 52% of the total value of the UK institutional client mandates held by its members. Of this figure, corporate pension funds accounted for approximately £1.0 trillion and local authority pension funds for £171 billion, the balance representing other categories. The survey report estimated total UK pension fund assets (under management of IMA members and others) as at December 2013 to be around £2.0 trillion.⁴

⁴ Asset Management in the UK 2012-13: The IMA Annual Survey, Section 3; Investment Management Association; August 2013

A small pension fund may be responsible for managing assets of some hundreds of millions of pounds, and a large one for tens of billions of pounds. A fundamental responsibility of a pension fund manager is, therefore, that of making very large amounts of money work effectively and securely in order to meet the pension liabilities of the fund as they fall due. It follows that, in order to avoid excessive fragmentation and thus cost, the minimum viable allocation of money by a pension fund to a single investment is relatively large. Exceptionally, a smaller fund may consider it to be around five million pounds; for a larger fund, it is more likely to be into tens of millions.

The scale of pension fund assets means that their investment strategies and decisions have the potential to make significant economic impacts. However, the fundamental responsibility of the trustees who oversee the management of these funds is to their members and pensioners. They are bound to act within actuarial and regulatory constraints designed to limit the levels of risk and cost to which the fund, and its ability to meet its pension obligations, is exposed. There is, therefore, an inherent aversion to significant levels of risk, and a preference for investments offering a very high degree of security and reliable returns. The events of recent years have, however, considerably undermined perceptions of security across a wide range of asset classes, and investments which satisfy those criteria and which offer any better than minimal returns have, for pension funds as for individuals, become increasingly difficult to find.

Possible responses to the challenge of generating worthwhile returns in a difficult climate include:

- minimising costs, for example by reducing the use of intermediaries in the investment management structure;
- adjusting the risk/return balance for a limited proportion of a fund's resources, accepting a higher level of perceived risk provided that this offers a realistic prospect of significantly higher returns.

In evaluating any category of investment, particularly if it is perceived as higher risk, pension funds will consider a variety of factors. They will require to be satisfied that institutions or intermediaries to whom their funds are entrusted have the appropriate expertise to undertake due diligence on and manage investments – often an area of some concern. They may in some cases, depending on the type and status of the fund involved, focus on the liquidity of the underlying assets involved (i.e. how readily and rapidly, and at what cost, they can be traded). They will also consider any available measures to spread risk – in some contexts, for example, a “fund of funds” approach has been seen as a way of doing this, although this has increasingly come to be regarded as an expensive option. There is now an inclination to look instead at mechanisms which share risk by co-investment with others, thus removing at least one layer of management and thus cost.

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The climate of recent years has caused some concern over the tendency for any apparently promising new area of investment opportunity rapidly to attract an oversupply of capital. This tends to change the behaviours of the parties involved, often creating a “bubble” that may distort pricing and judgement of quality of opportunities. It has been suggested that UK pension funds may be particularly vulnerable to this, as their trustees rely to a considerable extent on external advisers and consultants in establishing their investment strategies and making investment decisions. This may, arguably, have a tendency to reinforce “bandwagon” effects. Funds in other parts of Europe and the US tend to maintain a more sophisticated internal analytical and decision-making capacity, which may lead to greater individuality and diversity in decision making.

As regards the capacity and inclination of pension funds to invest in the emerging growth company market, their size represents a challenge. There is a mismatch of scale – the minimum thresholds of investment that are viable for the funds are generally of a higher order than the levels of investment required by individual emerging businesses. The funds themselves have no wish, nor do they have the expertise, to be involved in placing or managing individual investments at a level relevant to a single small or medium-sized company.

There is, therefore, invariably a need for some intermediary mechanism to enable investment sourced from pension funds to be deployed in emerging growth companies. This has been the role conventionally played by the venture capital (VC) sector. As discussed further in Section 2.2.4 below, VC as an asset class has to a large extent fallen out of favour with large institutional investors in recent years. Investments placed by pension funds into VC in the late 1990s and early 2000s proved to be disappointing, and significant changes since then in the regulatory environment for pension funds have also made them less inclined to consider this type of investment.

The potential for pension fund investment to create significant economic impact has been noted. However, investment perspectives and benchmarks are global, and the core responsibility of the funds is to pay their members' pensions, not to stimulate the economic development of any specific state or region. Some pension funds, particularly public sector funds, may occasionally be influenced by their capacity to play a supportive investment role in their own “domestic” economy (i.e. that in which the majority of their members are domiciled), but only to the extent of a minimal proportion of their overall assets. This is not to suggest that any pension fund investment is ever likely to be made on the basis of “soft” criteria – any decision must be entirely justifiable in terms of returns to the fund.

The economic background of recent years, in particular the need to bring public expenditure under control, has focused attention on new mechanisms to enable pension fund assets to be deployed in ways intended both to meet economic priorities and also satisfy the objectives and criteria of the funds. An example is the Pension Infrastructure Platform (PIP), a joint initiative involving the UK Government and the pension fund sector.

The Pension Infrastructure Platform is a joint initiative launched in November 2011 by the signature of a Memorandum of Understanding between HM Treasury, the National Association of Pension Funds (NAPF) and the Pension Protection Fund (PPF).

The UK Government wishes to increase spending on infrastructure in a climate of severe public spending constraints. UK pension funds have conventionally had relatively low exposure to infrastructure investment, which can lend itself well to providing inflation-linked returns to match their liabilities. The objective of the PIP is to enable pension funds to access infrastructure investment opportunities and expertise on terms more aligned to their needs than those previously available in the market. The stated aim is to achieve returns equal to RPI plus 2 – 5%.

The original intention was to attract £2 billion of investment from between 10 and 12 pension funds into the PIP, and to have it operational by the beginning of 2013. By February 2013, ten founding investors had been announced, many being the pension funds of local authorities or companies privatised from public ownership during the 1980s. Each had made a “soft” commitment of £100 million to the platform, taking it half way to its target. Progress towards an operational launch was, however, slower than anticipated. In February 2014, NAPF announced the first PIP fund, with an intended capitalisation of £500 million, of which £260 million had been committed at launch by five of the founding investors.⁵

At the same time, three of the founding investors pulled out of the PIP, apparently partly because its risk/return profile and costs no longer matched their requirements.⁶ It appears that the matter of construction-related risk may have been an issue of concern to some founder investors, who may have hoped that government guarantees would underwrite such risk.

Whilst the PIP addresses an area of investment whose characteristics are very different from the growth venture market, it does indicate that pension funds are open to considering innovative structures if they are well designed and clearly intended to address evident shortcomings in current market performance. Nonetheless, alignment of the risk/return requirements of pension funds with investment vehicles targeted at economic development outcomes can be challenging. In the context of investment in emerging growth companies, issues likely to be of concern to pension funds would include:

- perceptions of risk – particularly the pattern of a small number of outstanding investments compensating for the loss-making majority, historically characteristic of the venture capital sector;
- length of the timescale to achieve returns and lack of liquidity during the intervening period;
- the scale of the market and its capacity consistently to deploy enough capital to be significant to pension fund investors;
- achievement of an acceptable spread of risk. This becomes more acute if a specific geographic or sectoral focus is introduced to the equation.

⁵ Pension Infrastructure Platform announces PIP PPP equity fund; NAPF Press Release; 26 Feb 2014

⁶ "UK schemes abandon infrastructure platform over costs, returns"; Investment & Pensions Europe; 26 Feb 2014

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2.2.2 Life Insurance Companies

Historically, life insurance companies have been investors in risk assets. In particular, they maintained large holdings in equities that backed liabilities such as with-profits funds. However, major regulatory changes in recent years (specifically the EU Solvency II Directive) have had a significant impact on the insurance sector in terms of reducing acceptance of volatility in investment portfolios and mismatch with liabilities.

Further, as the capital costs associated with traditional guarantee products have increased, so have these products become unviable. Many traditional insurers are now turning to different business models, such as “fund supermarkets”, where they create investment platforms that match funds and individuals, rather than leaving the investment of funds to the discretion of the insurer.

One area of growing interest has been ‘infrastructure’ investment. Insurers with large annuity liabilities are attracted to this because it can provide low-risk returns that are inflation-linked, an ideal backing for annuity liabilities. However, recent changes to pensions regulation in the UK, which could reduce the demand for annuities, have led to several insurers rethinking their ability and appetite to invest in long-term illiquid investments such as infrastructure.

Consequently, it is difficult to see such institutions as sources of funding of the type being considered.

2.2.3 Fund Managers

The freedom for fund managers to invest in certain assets is restricted by the regulatory position of their clients or the stated objectives of the funds they manage. So, for example, it is the trustees or other governing bodies, normally as advised by actuaries or consultants, who decide where and how to invest the fund. Of course, the fund manager does generally have some discretion, but this will rarely stretch to the types of investment considered here. Investment is, for example, typically limited under institutional mandates to quoted companies and instruments.

There is a big difference between the risk appetite of, for example, business angels investing their own money and that of fund managers making investment decisions on behalf of others. Fund managers are careful of their own reputations and naturally have greater aversion to risk than is often compatible with support for propositions that may be very promising but still have much to prove.

Fund managers are also required to do substantial procedural and due diligence work to justify their decisions. This is costly and makes investments of less than a critical size uneconomic.

Managing illiquid investments in developing companies requires a particular investment approach that is very different from that followed by typical fund managers who are resourced to build portfolios of, generally, liquid or quoted securities.

2.2.4 Venture Capital Funds

In the overall context of this document, venture capital (VC) funds are not strictly speaking sources of capital. However, VC firms have for several decades been important channels for the investment of risk capital in unquoted companies, and some discussion of their history and role is relevant. The modern venture capital model began to emerge in the USA immediately after the Second World War. One of the first venture capital firms was American Research & Development Corporation (ARDC), established in 1946. ARDC is believed to have been the first firm to draw in capital from institutional sources for venture investment, thereby entering an arena which had previously largely been the preserve of extremely wealthy families. ARDC's \$70,000 investment in Digital Equipment Corporation (DEC) in 1957 would translate into a value of over \$350 million when DEC floated in 1968, doing much to stimulate interest in this type of activity.

A further step towards the creation of a professionally managed venture capital sector in the USA was the passage in 1958 of the Small Business Investment Act, enabling the creation of "Small Business Investment Companies" to support the financing and management of small entrepreneurial businesses. The 1960s saw the emergence of the partnership structure still generally used by VC firms today. This involves the subscription of capital by a group of passive Limited Partners (for example pension funds or other institutional investors, sovereign wealth funds, ultra-high net worth individuals, etc.) into a fund managed by professional General Partners. The compensation structure established for the General Partners, and still generally applied today, was based on an annual management fee (typically of the order of 2%) and a share of the profits of the partnership (typically 20%) known as a "carried interest". This "two and twenty" model is still in common use, usually linked to a fund with a defined intended lifespan, typically ten years, after which capital is returned to the investors.

The high-profile successes of the sector in the 1970s and early 1980s led to a proliferation of VC firms. The number of firms operating in the USA grew from a few dozen at the beginning of the 1980s to around 650 at the end of the decade, and their capital under management grew from around \$3 billion to \$31 billion.⁷ This growth in VC investment activity arguably resulted in oversupply, leading to loss of focus and undermining quality. To compound this, the market for initial public offerings was decimated by the stock market crash of 1987. These and other factors led to sharply declining returns on VC investment, and by the end of the 1980s these were at historically low levels, some firms even showing losses.

There followed a shakeout of VC managers, and the more successful firms regrouped and refocused on the quality and management of their portfolio companies. This set the scene for the sector as it entered its next boom period, driven by the dramatic surge of interest in information and communication technologies as the internet era arrived in the mid 1990s.

⁷ "Venture Capital Loses its Vigor"; Andrew Pollack; *New York Times*, 8 Oct 1989

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There followed a period of increasingly “irrational exuberance”⁸, as markets inflated perceived values of internet-related technologies and businesses to staggering levels. VC managers rode this wave enthusiastically until the “dot.com bubble” eventually burst in March 2000. The subsequent collapse of valuations of technology companies⁹ forced many VC firms to write off large proportions of their portfolios, leaving many funds showing major losses. By mid-2003, the sector had shrunk to around half its 2001 capacity, and is in many respects still living with the aftermath of this experience.

The origins of venture capital investment in the UK also date back to the immediate post-war period, but differed significantly from the US experience. In 1945, the Industrial and Commercial Finance Corporation (ICFC) was formed by the Bank of England and major British commercial banks to address a perceived shortage of available long-term investment funding for small and medium-sized companies. A sister organisation, Finance Corporation for Industry, also established in 1945, was subsequently absorbed by ICFC in 1973, and the new body re-named Finance for Industry (FFI). FFI became a major source of finance for management buy-outs in the UK and internationally, and in 1983 was re-named Investors in Industry, commonly known as 3i. In 1987 the commercial banks’ interests in 3i were transferred to a new company, 3i Group, which was floated on the London Stock Exchange in 1994.

Through the 1980s and into the 1990s, 3i was a pre-eminent provider of equity investment for new and emerging companies in the UK but, following its flotation, largely withdrew from this market.

The 1980s saw the gradual growth in the UK and Europe of a private equity sector, including the emergence of VC firms along similar lines to the US model. A representative body for the sector, the British Venture Capital Association (BVCA) was established in 1983, as was its European counterpart (EVCA). UK private equity investment grew from a few hundred million pounds per year in the early 1980s to over £6 billion per year at the height of the dot.com boom in 1999/2000¹⁰.

It was also during this period that the Scottish Development Agency (now Scottish Enterprise) established its Scottish Development Finance division to act as a catalyst in the provision of risk capital in Scotland. Through much of the 1980s and early 1990s 3i and SDF, often together, were the main investors in ambitious and early-stage Scottish businesses. In 2000, Scottish Development Finance was the subject of a management buy-out from Scottish Enterprise, and it became the private sector VC firm Scottish Equity Partners (SEP).

⁸ The memorable phrase used by Alan Greenspan, then Chairman of the US Federal Reserve, in a speech to the American Enterprise Institute in December 1996

⁹ The technology-focused US NASDAQ Composite Index peaked at 5132.5 on 10 March 2000. By late May 2000 it had fallen below 3200 and by September 2001 had sunk to below 1500. Its subsequent low point was 1108.5 on 10 October 2002. It has never yet regained its March 2000 level

¹⁰ *Private Equity – a UK Success Story*; BVCA; Feb 2006

As the venture capital model evolved through its early decades, one practice that became a standard element of its investment model was that of requiring that the shares issued to VC investors in a company carried liquidation preferences. Essentially, this means that on an exit event (for example, a trade sale or liquidation of the company), these shares carry the right for the capital originally invested (or sometimes some multiple of that capital) to be returned before any distribution of value to holders of ordinary shares. The terms of the preference can vary significantly. They may be designed primarily to provide a VC investor with a degree of protection against loss, or they may be sufficiently aggressive that the outcome of an exit event is very likely to be seen by earlier investors as inequitable. This is often quoted as one of the primary constraints on business angels and VC investors working together, as business angels who have made early-stage investments tend not to be attracted by the prospect of the company involved going on to seek VC investment. This is particularly the case in the UK, where the personal tax incentives for angel investment are at present applicable only where ordinary shares are held. This is discussed further in Section 2.3.1 below.

The early part of the 21st Century has not been kind to the VC sector. The collapse of the dot.com bubble gave rise to significant losses, particularly in newer VC funds with relatively inexperienced managers which had been set up as the bubble inflated during the late 1990s. Even larger and more experienced operators struggled in many cases to achieve acceptable – or indeed any – returns. The ten-year fund model meant that the impact of the 2000 to 2002 period continued to be felt through most of the subsequent decade, and the sector as a whole disappointed many of its limited partner investors. Even before the impact of the dot.com bubble had fully worked through the sector, the financial crisis of 2008 struck. The resulting comprehensive crash in the global financial sector led to the drying up of mergers and acquisitions (M&A) and initial public offerings (IPOs), both of which are needed to enable exits, and therefore returns for VC funds. In a risk-averse climate, major institutional investors questioned the attractiveness of VC as an asset class, and began to reduce their allocations of capital to VC funds – in some cases to zero. Many VC firms have failed to raise further funds, or have been forced towards more specialised activities which can more predictably provide a return.

Many large VC managers, such as 3i and Apax, switched away from risk capital and now mostly seek private equity (PE) opportunities, acting effectively as alternatives to public offerings for more mature businesses. Many others, such as SEP, moved towards larger later-stage investments (although SEP has recently moved back to a degree to considering somewhat earlier stage opportunities). The sector as a whole effectively ceased to be a provider of investment to startup and seed stage companies.

This situation has led some commentators to argue that the VC model is fundamentally broken. In May 2012, the Kauffman Foundation in the USA published a report on research based on its own experience as an institutional investor in around 100 VC funds over a 20-year period¹¹. This research showed that only 20 of the 100 venture funds in which it had invested had generated returns that exceeded a public-market equivalent by more than 3% per annum, and that 62 of the 100 funds had, after fees and carried interests were paid, failed to exceed the returns available from public markets.

¹¹ “We have met the enemy... and he is us”; Ewing Marion Kauffman Foundation, May 2012

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The report was highly critical of the conventional VC firm remuneration structure (the “two and twenty” model referred to above), concluding that it can allow VC managers to “lock in high levels of fee-based personal income even when the general partner fails to return investor capital”. It also criticised a perceived lack of transparency in VC firm financial performance and shortcomings in governance. Interestingly, the report laid the primary responsibility for these shortcomings at the door of the limited partner investors in VC funds, rather than the general partners managing them. It suggested that limited partners have not generally been sufficiently rigorous in their analysis of VC performance or forceful in their negotiation with VC firms, concluding that “institutional investors will need to become more selective and more disciplined investors in venture capital funds”.

This raises the question of how the future of the VC sector will look. For the time being at least, part of the answer appears to involve increased public sector participation aimed at leveraging in capital from private sources. In 2006, the UK Government established the Enterprise Capital Funds (ECF) programme, intended to stimulate the provision of relatively small-scale equity investment (up to £2 million in a first round). Under this programme, the Government commits up to £50 million (recently increased from £25 million) of public money as a limited partner in each ECF, representing up to two thirds of the total fund. The balance has to be subscribed by private sector investors. The ECFs are managed by private sector VC managers, and are required to pay a prioritised return equivalent to 3.0% (reduced from an original rate of 4.5%) compound interest on the public money subscribed, and to return to the Government a fixed negotiated share of the profits on the fund. Sixteen such ECFs have been set up to date, the majority of them based in southern England, predominantly the London area. The only one so far established in Scotland (Panoramic Growth Equity, based in Glasgow) has made approximately equal numbers of investments here and in other parts of the UK.

In March 2013, the UK Government announced in an update on plans for its new British Business Bank that the Enterprise Capital Fund programme will receive a new allocation of £25 million for a VC Catalyst Fund.¹² This is intended to provide modest incremental assistance (in the range of £5 to £10 million) to new VC funds of at least £50 million total size, to enable funds which have already received significant commitments to reach a close. The new Business Bank is expected to become operational in late 2014.

Another recent arrival on the UK Venture Capital scene has been the Business Growth Fund (BGF), launched in 2011 by five large banking groups with Government encouragement. BGF is an independent company with the capacity to commit up to £2.5 billion to long-term growth capital investments. Its stated focus is the provision of growth capital in the £2 million to £10 million range for established companies with clear potential. Its structure and approach differentiate it to some extent from the conventional venture capital model, and its very substantial resources give it the potential to be a significant influence – it has been described as “the new 3i”.

¹² Building the Business Bank – Strategy Update; Dept. for Business Innovation & Skills; March 2013

It represents competition to established operators in the VC and private equity sector and, perhaps not surprisingly, has been the subject of some criticism from that quarter.¹³

Nonetheless, its impact and momentum are clearly growing – for example, its portfolio in Scotland started with two investments in early 2012, grew to around five by mid-2013 and by April 2014 had reached thirteen, amounting to a total of over £70 million.

BGF's investment criteria state that it seeks to make investments of between £2m and £10m in companies turning over between £5m and £100m. Its investments in Scotland have ranged fairly evenly in size between £2.25m and £10m. The companies involved have been substantial businesses, although their turnover figures appear generally to have been towards the lower end of BGF's stated range – most have been between about £5.0 and £25–30m. It is clearly finding a market, although its minimum threshold, particularly in terms of company size, is fairly high in the Scottish context. This positions it out of the reach of what may be a fairly sizeable constituency of companies which have, for example, grown to a turnover of £1–2m or thereabouts on the back of business angel investment, and could go a great deal further given access to follow-on funding.

Finally, it is worth noting the European Commission's recent Alternative Investment Fund Managers Directive¹⁴, which came into force in July 2013. This sets out a common European framework for the management and regulation of a range of entities, including private equity funds, hedge funds and retail investment funds. Subsequent associated legislation¹⁵ has introduced a regulatory regime applicable to qualifying venture capital funds, which will be able to use the designation "EuVECA". One stated objective is to provide increased confidence for investors in such funds, and to enable them to raise money more readily from sources across the whole of the EU. These provisions, aligned with the overall vision of the Europe 2020 Strategy – "a strategy for delivering smart, sustainable and inclusive growth" – are intended to stimulate the supply of venture capital investment into innovative small companies.

2.3 High Net Worth Individuals and Family Offices

2.3.1 High Net Worth Individuals

Investment by private individuals is an important source of capital for early-stage unquoted companies. In some cases, such investors may have family or other personal connections with the company founders. In other cases, where there are no such prior relationships, the investors involved, often described as "business angels", are in almost all cases high net worth individuals (HNWIs).

¹³ "Private equity heads criticise Business Growth Fund"; Financial News; 18 Oct 2013

¹⁴ Directive 2011/61/EU of the European Parliament and of the Council – 8 June 2011

¹⁵ Regulation (EU) No 345/2013 of the European Parliament and of the Council on European venture capital funds – 17 April 2013

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Varying definitions of a “high net worth individual” are applied by different organisations and in different circumstances. The most relevant definition in this context is that embodied in UK legislation relating to the promotion of investment schemes, specifically the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005. This contains provisions intended to create a relatively lightly regulated environment for small companies wishing to issue information to prospective business angel investors. It is based on a process of certification of such individuals as either “sophisticated investors” or “high net worth individuals”. In essence, it defines HNWIs as having either an annual income of at least £100,000, or net investable assets of at least £250,000. Most definitions of HNWIs in other contexts set considerably higher criteria.

Recognising both the risks and the importance of this type of investment in small unquoted companies, the UK Government has, over several decades, sought to stimulate it by the provision of tax incentives. The principal current measure relating to direct personal investment in such companies is the Enterprise Investment Scheme (EIS), introduced in 1994. EIS provides for income tax, capital gains tax and inheritance tax relief in respect of qualifying investments.¹⁶ More recently, the Seed Enterprise Investment Scheme (SEIS), introduced in 2012, enhanced the level of tax relief for limited amounts of investment in businesses less than two years old.¹⁷

It has been suggested that the UK Government has now gone about as far as it realistically can in using the personal tax regime to encourage investment by private individuals in unquoted companies. Having said that, it may be argued that these tax reliefs constitute an investment by Government rather than a subsidy, as business angel-backed companies are likely to generate far more in payroll taxes alone than the amount of EIS relief involved in the angel investment. There are ways in which tax reliefs could be extended – for example, by applying relief to interest payments to encourage lending by private individuals to qualifying companies.

One of the conditions of EIS is that tax relief is available only in respect of investments in full-risk ordinary shares of the company involved. Shares may carry limited preferential rights in respect of dividend payments, but no preferential rights in the event of the company being wound up.¹⁸ As discussed in Section 2.2.4, this tends to create some tension between the interests of angel investors and VC funds, which routinely require that their shares carry liquidation preferences. These are generally regarded as likely to be seriously disadvantageous to earlier investors holding ordinary shares.

¹⁶ www.hmrc.gov.uk/eis

¹⁷ www.hmrc.gov.uk/seedeis

¹⁸ An Introduction to the Enterprise Investment Scheme, Section 1.1; HM Revenue & Customs; www.hmrc.gov.uk/eis/part1/1-1.htm

As well as the issue of liquidation preferences, there are other reasons why business angel and VC investors may find it difficult to work together. Discussion of this topic during a workshop event held at the Royal Society of Edinburgh in May 2012¹⁹ alluded to a number of factors which may cause angel investors to regard the prospect of their portfolio companies seeking subsequent venture capital investment as uncomfortable. These include the probability that embarking on a new phase of growth and development will carry with it new and challenging targets and the need for fundamental management changes. There can also be significant differences between the perceptions of angels and VCs in terms of the valuation of companies. In view of all these factors, angel investors may well prefer to see portfolio companies go to trade sale rather than seek follow-on investment to support continuing growth as independent entities. Often, the overall business and market context may be such that this is indeed the optimum outcome, but in some cases it may mean that opportunities to create more substantial independent indigenous companies are lost.

Since 1994, over 20,000 companies have used the EIS to raise a total of over £9.7 billion. The most recent HMRC provisional statistics available²⁰ indicate a dramatic rise in tax year 2011–12 over the previous year in the overall level of EIS-qualifying investment in the UK from £545 million (2010–11) to £1,017 million (2011–12). This may not, however, reflect an upsurge of interest in investing in growing businesses. It is believed to be attributable in large measure to the inclusion of electricity generation eligible for Feed-in Tariff or similar subsidies as a qualifying activity under EIS rules. The rules were changed to exclude this activity from EIS relief as from 6 April 2012.

A geographic breakdown (based on company registered office addresses) indicates that the vast majority of EIS investment activity takes place in London and the southeast of England, which between them accounted in 2011–12 for 1,486 of the 2,596 companies receiving investment, and £754 million of the total £1,017 million invested. In the same year, Scotland accounted for 155 (6.0%) of the companies receiving investment, and £34 million (3.3%) of the UK investment total, figures in the mid range of those for UK regions other than London and the southeast of England.

¹⁹ “The Financing of Business Innovation in Scotland”, RSE Advice paper 12–10, Section 2.3; October 2012

²⁰ www.hmrc.gov.uk/statistics/enterprise/eis-commentary.pdf

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TYPES OF BUSINESS ANGEL INVESTMENT

As the business angel market in the UK has developed and matured, a number of identifiable sub-sectors have emerged. These may be categorised broadly as follows:

- > Solo Angels
- > “Super” Angels able to commit upwards of £1 Million to a single investment
- > Business Angel Networks
- > Business Angel Syndicates
- > EIS Funds

Solo Angels

Solo angels cover a spectrum of circumstances and levels of experience. At one end, there are relatively inexperienced and financially naive individuals, often with personal connections to the founder of a business (sometimes described as “friends, family and fools”) who, incidentally, may or may not be high net worth individuals. At the other, there are sophisticated investors, often cashed-out entrepreneurs who typically invest in businesses where they have some domain experience and can provide operational as well as financial support.

Super Angels

The proportion of business angel transactions involving individual investments of £1 million or more is very small. The upper limit of eligibility for EIS relief for an individual investor has only recently been raised to £1 million per year (increased in tax year 2012–13 from the previous limit of £500,000), and no statistical evidence of the impact of this is yet available. Informed commentators suggest that there are very few business angels in Scotland willing to commit £1 million or more to a single investment. A few such transactions are known to have taken place, but they are still exceptional in the Scottish context. Super angels will typically have some relevant domain experience and a strategic view of the investment, and will carry out extensive due diligence and enter into legal agreements incorporating comprehensive investor protections.

Business Angel Networks

A network model has been broadly characteristic of the development of the business angel market in England and Wales. A number of bodies have been established, many with a regional focus, to facilitate interaction between angel investors and companies seeking investment. Typically, they act as portals through which companies can be introduced to angel investor communities, and as brokers between these companies and their angel investor members. They may assist their members to establish *ad-hoc* syndicates for specific investments, but they do not operate as standing investor syndicates. The regulatory environment makes this model, in some respects, fairly onerous from an administrative and compliance point of view.

In many cases, such networks were run by the former regional development agencies (RDAs) or other public sector bodies. Following the demise of the RDAs, some of these networks are believed have fallen into decline whilst others continue to operate and apparently to thrive.

The establishment in 2011 of the Angel Cofund²¹, using a model similar to the Scottish Co-investment Fund, was a significant innovation in the business angel market in England. One consequence is that groups of business angels in England now have to be established as organised syndicates in order to make a joint investment with the Angel Cofund. Whilst there is no requirement for such syndicates to be formally constituted or to make a long-term commitment to multiple investments, it seems likely that an increasing number of syndicates of this type may emerge over time.

Business Angel Syndicates

The syndicated model has been evolving in Scotland over more than twenty years. It follows the general approach adopted in the USA and has been copied in a number of other jurisdictions. LINC Scotland²², the lead body for the sector, has since its establishment promoted the syndicated investment model. The Scottish Co-investment Fund has, since its launch in 2003, played a major role in stimulating the creation of formal managed business angel syndicates, and the infrastructure that has emerged is now recognised internationally as a model of good practice in business angel investment. As experience has been gained, regulatory compliance issues have been addressed in a rigorous but pragmatic fashion, and the syndicated model has enabled investment transactions to be conducted in an appropriately compliant environment, without excessive administrative overhead or inefficiency.

EIS Funds

The description EIS “fund” is something of a misnomer, as these are not unified collective investment vehicles but rather managers and aggregators of collections of individual EIS-qualifying investments. Their administration is relatively complex, requiring:

- a detailed Investment Memorandum to promote the fund;
- a separate Investment Management Agreement for each individual Investor in the fund;
- a separate Custodian and Nominee Agreement for each individual Investor whose cash funds and shareholdings must be held by an authorised Custodian, typically through a nominee company.

²¹ www.angelcofund.co.uk

²² www.lincscot.co.uk

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Launch costs are typically in the region of 5%, and marketing is usually through financial intermediaries to retail clients or high net worth investors. The manager typically levies a 2% management fee and takes a 20–25% profit share on the realisation of each investment.

Most operate at a relatively modest scale (i.e. not exceeding £5 million of funds under management), and therefore tend to face a number of challenges, e.g.:

- insufficient funds to build a wide enough portfolio to spread risk adequately;
- insufficient cash to follow their money on subsequent investment rounds, with consequent risk of dilution;
- difficulty in generating sufficient fee income to meet the costs of providing effective management.

They may, therefore, struggle to operate viably as stand-alone funds, a more appropriate role possibly being as “sidecar” funds for managers who have other more substantial funds under management.

The advent of the Seed Enterprise Investment Scheme has seen the emergence of a number of “SEIS funds”, the likely performance of which is probably even more questionable than that of EIS funds.

SCALE OF BUSINESS ANGEL INVESTMENT

Business angel investment is essentially a private arrangement between an individual or group of individuals and a company. As outlined above, some angel investment activity is channelled through fairly formal bodies (e.g. managed syndicates) which may voluntarily release some information on their activities into the public domain. Some is relatively informal and thus is not identifiable or quantifiable from any public information source. Where any public domain information is available, it may disclose only an overall amount raised by a company in a funding round. This may include elements of grant funding or equity investment from other sources as well as angel investment, and may relate to investment commitments over a period of years, rather than a single funding injection. All of this makes it difficult to estimate the overall volume of business angel investment activity in Scotland. A number of estimates have been made in recent years, and these show some variation.

A Scottish Enterprise report of December 2012²³ appears to indicate that angel investment in Scottish companies ran at around £15 million per year during the period covered.

23 The Risk Capital Market in Scotland 2009–2011

A review of UK business angel activity in 2009/10²⁴ referred to investments reported by members of the business angel association LINC Scotland. The review indicated that during that year LINC members had been involved in a total of 78 investments, the overall sum involved having been £27.5million, of which £18.2 million was reported to have been angel investment. The review also referred to an estimate that LINC members became aware of around 35% of the angel deals undertaken in Scotland, and on this basis suggested that the total annual level of angel investment might be of the order of £50 million.

HMRC statistics²⁵ indicate that the total of EIS-qualifying investment in Scottish-registered companies was £30 million in each of tax years 2009–10 and 2010–11, and rose to around £34 million in tax year 2011–12. Other sources suggest that EIS is used in a major proportion of, but not all, angel investments. Research undertaken for a 2009 NESTA report considered a sample of 1080 investments made by 158 individual UK angel investors, and found that EIS had been used in 57% of the investments in the sample and had been used at least once by 80% of the investors. A recent academic research report²⁶ refers to surveys of investment activity by individual business angels undertaken in 2008/09 and 2009/10. These indicated that 70% of them had used EIS for at least some of their investments (although just over half that proportion had used it for all their investments). On this basis, it would seem reasonable to estimate that over half but less than two-thirds of angel investment is reflected in EIS statistics, and that the annual investment total in Scotland may therefore be in the region of £50 – 60 million.

BUSINESS ANGEL INVESTMENT RETURNS

The essentially private nature of business angel investment, as noted above, means that accessible data on investment returns is limited. A 2009 NESTA report²⁷ addressed the topic, based on data obtained from a sample of 158 business angels who had collectively invested a total of £134 million in 1080 different investments. At the time of the study 406 of the investments had reached an exit (i.e. a termination of any type – flotation, trade sale, liquidation or other). The study was conducted in association with the British Business Angels Association (now re-named the UK Business Angels Association), which fulfils in England, Wales & N. Ireland a role similar to that of LINC in Scotland. The study evidence and conclusions, therefore, relate largely to parts of the UK other than Scotland.

²⁴ Annual report on the Business Angel Market in the United Kingdom 2009–10; Colin Mason & Richard Harrison; May 2011

²⁵ www.hmrc.gov.uk/statistics/enterprise/eis-commentary.pdf

²⁶ “Business angel investment activity in the financial crisis”; Colin Mason & Richard Harrison; July 2013

²⁷ “Siding with Angels”; Robert E. Wiltbank; NESTA Research Report; May 2009

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In terms of returns on investment, the emerging picture is one of high risk, but with the possibility of high returns. Analysis of the exits indicated that 41% involved the total loss of the sum invested; 15% involved a loss, but returned some proportion of the sum invested; 35% returned between one and five times the original investment; and 9% returned over ten times the original investment. Aggregated across the whole sample, the overall multiple at exit was 2.2 times the original investment and the approximate internal rate of return (IRR) was 22%. A similar study involving a sample of 1137 exits from investments by business angels in the US²⁸ yielded an overall multiple at exit of 2.6 times original investment and an IRR of 27%. The average holding period from investment to exit was quoted as 3.6 years in the UK study and 3.5 years in the US study. However, exits at a loss generally occurred more quickly than successful exits: the average holding period to a loss-making exit was 3.2 years in the UK sample, whereas exits returning multiples over ten times took approximately eight years to achieve.

THE SCOTTISH ANGEL INVESTMENT ENVIRONMENT

The organisation and co-ordination of business angel investment in Scotland has a history dating back some twenty-five years. It has developed and evolved in a somewhat different way from the rest of the UK. As discussed above, it has been based largely on a syndicate rather than a network model. LINC Scotland has advocated a syndicate approach virtually since its establishment and, over the past ten years, the existence of the Scottish Co-investment Fund has played a major role in incentivising the creation of new syndicates. The decade following the launch of the Fund saw the number of angel syndicates in Scotland grow from two to around twenty, and this has clearly enriched the environment for early-stage companies requiring seed investment.

Within the last few years, particularly following the financial crisis of 2008, commentators have begun to suggest that the business angel sector may be under a degree of stress. Reference has increasingly been made to the scarcity of exits for angel investors in recent years. This has been attributed to various factors, including the overall economic climate and the need for seed investors to continue to support companies for longer than originally anticipated (e.g. by providing working capital that, prior to 2008, would have been obtainable by bank borrowing). Timescales from first investment to exit are now often ten years or more. Concern has been expressed that a degree of disillusionment and “investor fatigue” may be setting in, although it is difficult to find objective evidence of how prevalent this sentiment is. It is, however, clear that little capital has been released from existing investments for some time, and this absence of liquidity events must impact on both the amount of cash available for recycling into new investments and the motivation of investors. It is noticeable that the term “replacement capital” (i.e. the buyout of seed investors by later investors) has entered the investment lexicon in recent years. A number of major investors, including the Business Growth Fund,²⁹ have indicated a willingness to consider this mechanism, which was virtually unknown a decade ago.

²⁸ “Returns to Angel Investors in Groups”; Robert Wiltbank & Warren Boeker; Kauffman Foundation & Angel Capital Education Foundation; November 2007

²⁹ www.businessgrowthfund.co.uk

These pressures on the business angel sector, together with the fact (as discussed above) that follow-on investment from VC funds is not usually a natural progression, have led to a tendency for angel investors to concentrate increasingly on specific types of companies. Broadly, these are businesses whose inherent characteristics are most likely to enable an exit to be achieved in a relatively short time without recourse to non-angel sources of funding. A typical profile would be a company that is believed capable of achieving a material market presence and a stable financial position (i.e. at least break-even) within about five years with a total injection of equity investment of around £2 million. Companies with higher capital requirements, for example for pre-market regulatory compliance (e.g. in the biomedical and pharmaceutical sectors) or for large-scale prototype development (e.g. in the renewable energy sector) are less favoured than less-capital-intensive businesses with relatively low barriers to market entry.

As outlined above, the environment in Scotland is characterised by a few older syndicates with long track records and a high proportion of newer and less experienced ones. Few of the newer syndicates – even those which have been in existence for five to ten years – have yet seen an exit. Recent research on this topic³⁰ has suggested that the dramatic growth in the number of angel syndicates in Scotland has led to a preoccupation with the process of making investments (evaluation, due diligence, terms of the deal, etc.) rather than a focus on longer-term outcomes. It is suggested that investors have given relatively limited attention to the likelihood of satisfactory exits, or to the process of management towards an exit. There may be a significant number of companies in angel syndicate portfolios which, although viable businesses, will never provide positive returns for their investors. This “living dead” phenomenon is of course a characteristic of angel portfolios globally (as discussed above), but the suggestion is that some Scottish syndicates have yet to confront this reality by either writing off such investments or making pragmatic disposals for whatever value can be realised.

This has implications not only within the business angel community but also for the public sector. The Scottish Co-investment Fund now holds what is almost certainly the largest single portfolio of unquoted company investments in Scotland, many of which are co-investments with angel syndicates. The translation of a proportion of these into high-return exits is critical to the long-term viability of the Fund. It is only realistic, however, to expect that a significant proportion of the portfolio companies will not achieve such exits. The management of these situations, as Mason and Botelho point out, may give rise to some challenges.

30 “The role of the exit in the investment decision of business angel gatekeepers”; Colin Mason & Tiago Botelho; December 2013

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2.3.2 Family Offices

The term “family office” is generally understood to refer to private wealth management advisory organisations designed to serve the needs of very high net worth individuals or families. These organisations vary significantly in terms of their modes of operation and the scope of the services they provide. One frequently-used categorisation subdivides them into “single-family offices” (SFOs), providing services for only one affluent family, and “multi-family offices” (MFOs), which bear a closer resemblance to the broader constituency of private client wealth management organisations. In either case, their activities may range from investment advisory and management services through budgeting, insurance, wealth transfer planning, taxation and charitable giving to the management of family businesses. Some, particularly single-family offices, may also have a wider administrative role extending to matters such as travel, household arrangements or private education.

The available information suggests, however, that family offices vary very widely in their characteristics, reflecting the unique circumstances of each of the families which they serve. A paper published in 2007 by the European Venture Capital Association³¹ suggests a classification reflecting differing structures and stages of inter-generational transition.

Family offices have been used for generations by affluent families in the USA as investment and wealth management vehicles. As well as continuing to grow in number and significance there, they have also become a significant investment force in other parts of the world, particularly within the last fifteen years or so.

An insight into the history and significance of family offices in the USA may be gained from a detailed ruling issued in 2011 by the US Securities and Exchange Commission.³² This relates to the exemption of single-family offices from regulation under the Investment Advisers Act. Amongst other provisions, it refers to a restriction on family offices continuing to act for family members beyond ten generations removed from a common ancestor, and sets out a revised approach to interpreting and implementing this restriction.

Estimates of the number of family offices and the resources they manage vary. One commercially available database claims to list a total of 1,089 family offices, of which 388 are US-based, 534 are European and the remainder (167) are in other parts of the world.³³

A 2010 article on trends in the development of family offices in the USA suggested that there were 2500 to 3000 SFOs managing total assets of more than \$1.2 trillion, and 150 MFOs managing total assets of approximately \$400 billion.³⁴

31 “Europe’s Family Offices, Private Equity and Venture Capital”; EVCA Special Paper; Nov 2007 – Section 4

32 www.sec.gov/rules/final/2011/ia-3220.pdf

33 www.familyoffices.com

34 “The Rise of the Multi-Family Office”; Pamela J. Black; Financial Planning; 27 April 2010

The 50 highest-ranked offices in the most recent MFO survey conducted by Bloomberg (based on 118 responses from over 1000 firms approached worldwide) had between them assets under management amounting to a total of \$918 billion. Forty of them (total assets under management \$639.4 billion) were based in the USA and the other ten (total assets under management \$278.7 billion) in Europe and Asia. The number of client families served by each office varied widely across the sample (from five to almost 3,500), the average number being approximately 320.³⁵

The Family Wealth Alliance in the USA conducts an annual study of SFOs, albeit based on an apparently very small sample size. Its 2012 study, based on information from 34 respondents, suggested that the mean value of assets under management was \$450 million and the median was \$320 million. It indicated that the assets managed by single-family offices vary widely in scale, from around \$20 million to \$1.8 billion³⁶. These figures should probably be treated with some caution, due to the sample size involved, and should be understood in the context of the introductory comments above – i.e. they are likely to refer to total family assets rather than external third party investments under management.

The EVCA paper referenced above³⁷ estimated that in 2007 there were around 500 family offices in Europe, and that 80 to 100 of these might be considered “large”, i.e. each having assets under management of over one billion Euros.

Family offices generally seek to operate in a discreet fashion. Single-family offices, in particular, tend to be characterised by a wish to maintain a low profile. They are private entities, not subject to the regulatory scrutiny and disclosure requirements applicable to organisations involved in retail investment or fund management, so very little information on their operations is publicly available. It can be difficult to engage with them – for example, they may not be amenable to direct approaches regarding investment opportunities, preferring or requiring introductions only through trusted intermediaries.

The investment priorities and thought processes of family offices tend to focus to a high degree on the preservation of wealth, suggesting an inherent aversion to risk. Many of their founders or clients, however, may have highly entrepreneurial personal or family histories and inclinations. The dynamics and timeframes of their investment decision making tend to differ significantly from those of, for example, venture or private equity fund managers. They may be inclined to take a longer-term view, considering timescales spanning generations, rather than being driven by a need for exits in order to demonstrate convincing returns within the lifetime of a specific fund. Their decision-making processes, particularly those of smaller single-family offices, may be relatively straightforward and quick.

Sections 7 and 8 of the EVCA paper (referenced above) discuss in some detail the investment practices and preferences of family offices. They suggest that the interests and inclinations of at least some family offices align closely and naturally with the timescales and risk profile of mid-range venture investment (i.e. at a scale beyond that normally associated with business angel investment).

³⁵ The Richest Family Offices: Bloomberg; August 2013

³⁶ Report on the Fifth Annual Single-Family Office Study; The Family Wealth Alliance; 2012

³⁷ “Europe’s Family Offices, Private Equity and Venture Capital”; EVCA Special Paper; Nov 2007

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2.4 Retail Channels

2.4.1 Background

It has been suggested that there may be a sizeable community of people who could be attracted to making investments in small unquoted companies, but not necessarily at the level or in the way in which business angels typically do so.

The most recently available HMRC statistics indicate that the number of individual investors claiming EIS tax relief rose significantly from 11,330 in 2010–11 to 19,044 in 2011–12.³⁸ Around a quarter of the investments involved sums of £5,000 or less, and close to 40% involved sums of £10,000 or less. While, as noted in 2.3.1, small-scale electricity generation projects may have accounted for much of the increase, there may be some suggestion of a growing appetite for relatively modest-scale investments in unquoted companies.

A far larger number of UK taxpayers, around 300,000, are liable for tax at the Additional Rate (applicable to annual taxable income in excess of £150,000).³⁹ It therefore seems reasonable to suggest that there may be potential for further development of the retail market for investment in unquoted companies.

A significant factor in this context is the major influence of independent financial advisers (IFAs) on personal investment behaviour in the UK. An important recent development in this sector has been the Retail Distribution Review, which came into effect at the beginning of 2013. This introduced new regulatory requirements aimed at broadening the scope and quality of the advice offered by IFAs and creating greater transparency in their charges. The impacts of this will become clearer with the passage of time.

2.4.2 Venture Capital Trusts

The Venture Capital Trust scheme, introduced by the UK Government on 6 April 1995, is designed to encourage private individuals to invest indirectly in relatively small trading companies whose shares are not traded on a 'main' stock exchange. Investments in such companies are perceived as carrying higher risks than investments in quoted companies, and the VCT scheme enables private investors to spread these risks across a portfolio of companies, whilst benefiting from certain tax incentives designed to make the overall risk/reward balance more attractive to them.

VCTs are themselves limited companies whose status for the purposes of the scheme must be approved by HMRC, and which must be admitted to trading on a regulated market recognised by the EU. Investors can participate by subscribing for new shares being issued by a VCT, or by purchasing VCT shares in the market. The VCT uses the money it raises from issuing its own shares and revenues subsequently retained from operating activities (e.g. dividends from or realisations of existing holdings) to make investments, at least 70% of which must be in qualifying unquoted trading companies, subject to a number of specified criteria.

³⁸ Enterprise Investment Scheme Statistics; HMRC; Dec 2013

³⁹ Income Tax Liabilities Statistics 2011–12 to 2013–14; HMRC

The tax incentives available to private individuals investing in a VCT are:

Income Tax reliefs

- Exemption from Income Tax on the dividends from ordinary shares in VCTs
- Income Tax relief at a rate of 30% on the amount subscribed (currently up to a maximum of £200,000 in any tax year) for new shares issued by a VCT (but not on the purchase of existing shares on a secondary market) provided that:
 - these are ordinary shares carrying no preferential or redemption rights during a period of five years from their issue date;
 - the individual making the investment subscribes for the shares in his or her own name, and holds them for at least five years.

Capital Gains Tax reliefs

- Exemption from Capital Gains Tax on disposal of VCT shares (whether originally purchased by subscription for new shares or on a secondary market), provided:
 - the shares were acquired within the permitted maximum investment limit for the relevant tax year;
 - the VCT held approved status with HMRC both when the shares were acquired and when they were sold.

To meet “qualifying investment” criteria, the companies in which VCTs invest must:

- have unquoted status, i.e. their shares must not be listed on any recognised stock exchange. Companies whose shares are traded only on the Alternative Investment Market are regarded as unquoted for this purpose. Shares in a company which ceases to be unquoted can continue to be treated as qualifying investments for the following five years;
- have a permanent establishment in the UK and be engaged in a “qualifying trade”. Qualifying trades are defined in terms of exceptions rather than inclusions – there are certain categories of activities which are excluded. These include, for example, financial services, land dealing and property development, agriculture and forestry, hotels, shipbuilding, coal and steel;
- have gross assets not in excess of £15 million immediately before the VCT investment, or £16 million immediately afterwards;
- be independent, i.e. not controlled by another company.

There are also criteria relating to the ownership of subsidiaries, the use by the company of the VCT investment and the rights which may attach to the shares held by the VCT. The amount invested by a VCT in any one company is effectively limited to £5 million per year under EU rules.

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HM Revenue & Customs statistics indicate that the number of VCTs in existence has been fairly stable since 2006–07, fluctuating between 120 and 130 over most of that period and declining slightly to 118 in 2012–13. They also indicate that, following a significant dip to £150 million in 2008–09, the amount of new funds raised annually by VCTs has fluctuated in the range £325 million to £370 million since then.⁴⁰

The priority of the majority of their retail investors is now yield rather than capital gain. Attractive yields are enabled because VCTs can distribute as dividends any capital gains made on their investments. They have come to be regarded as substantially de-risked investments, and have become, for many investors, a source of income in retirement. This has been reflected in a progressive shift of focus over the history of the VCT sector from early-stage companies with high growth potential, but also high risk, to rather later-stage and more established businesses. Very few VCTs now seek to invest exclusively in technology sectors, and the few that have done so (for example Oxford Technology VCT and the Octopus Titan VCT) have made their focus clear in their promotional material. The larger VCTs usually seek to balance their investments across a range of industrial and commercial sectors.

They act as a source of capital for trading companies in situations of change and development (for example, generational transition), and have a particular niche at present in that they are to some extent replacing what would in the past have been bank funding. The working relationships between VCTs and their portfolio companies vary – some VCT managers are inclined to be highly interventionist when, for example, changes of management are regarded as necessary; others may be less so. Few VCTs will invest to any great extent in early-stage higher-risk situations.

The cost to a VCT of selling new shares to retail investors is fairly high. Prior to the advent of the Retail Distribution Review, shares were generally sold through intermediaries, who typically took a commission in the region of 3–5%.

It would appear that, from an overall UK perspective, Scotland is now seen by VCT managers as a sub-optimal location. During the early years of the existence of VCTs, a number were based in or had offices in Scotland, including Murray VCT, Noble VCT and Northern Venture VCT. This is, however, no longer the case. For example, NVM Private Equity (formerly Northern Venture Managers) no longer has an Edinburgh base, its offices now being located in Reading, Manchester and Newcastle, with one director being based in Scotland.

2.4.3 Crowdfunding

Crowdfunding, a new method of attracting retail interest in risk financing, continues to develop and grow rapidly, with new players and platforms appearing on a regular basis. A representative body for the sector, the UK Crowdfunding Association (UKCFA), has now been established.⁴¹

The term crowdfunding is used as an all-encompassing term to describe a wide variety of types of models, objectives and relationships. At one end of the spectrum, platforms may be used to facilitate the flow of relatively small sums of money into community, social, arts or similar charitable projects. Individual subscriptions are typically of the order of a few tens of pounds, contributing to a total fundraise of the order of hundreds or a few thousand pounds. At the other end of the spectrum, crowdfunding platforms are being used to attempt to raise material amounts of equity investment of the order of tens or hundreds of thousands of pounds.

⁴⁰ www.hmrc.gov.uk/statistics/vct.htm

⁴¹ www.ukcfa.org.uk

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After a consultation process, the Financial Conduct Authority (FCA) has now revised the regulation of this activity in the UK⁴². It now insists that those operating peer-to-peer lending obtain a Consumer Credit Licence, and never hold funds in their own names. Those enabling crowdfunding for equity must only promote deals to certified ‘sophisticated investors’, otherwise they must take steps to ensure that individuals are not risking more than 10% of their net investable assets (i.e. excluding homes, pensions, etc.). This appears generally to have been well received by the sector, although there has been some criticism, one commentator saying “it takes the crowd out of equity crowdfunding.”⁴³

The use of crowdfunding to raise equity investment is seen as posing a number of significant challenges – for example, in dealing with the administration of subsequent funding rounds, managing pre-emption rights, etc. There is a concern that an early funding round raised by this means might prejudice a company’s ability to raise subsequent equity investment. However, UKCFA members are alert to these issues, and they may in due course be resolved by dialogue amongst the crowdfunding community, business angels and venture capital investors.

A recent paper for the US National Bureau of Economic Research⁴⁴ reports that ‘angel-led crowdfunding’, is becoming increasingly popular. In these situations, an individual ‘lead angel’ puts their name (and reputation) to a crowdfunding deal, declaring that they have undertaken due diligence, will invest a specified amount, and are willing to represent the other shareholders as a non-executive director. Individual crowdfunding investors often find such a proposition attractive, particularly as this is a method of investing directly in risk opportunities without incurring management fees. It should be noted that, for UK companies and investors, the EIS and SEIS tax incentives will normally apply to such deals.

However, a study in 2013 by Twintangibles for the Glasgow Chamber of Commerce found that Scotland was underperforming in this new method of risk finance compared to the rest of the UK (where an estimated £200m was raised in 2012). The report found that although knowledge of crowdfunding was “reasonably high” amongst Scottish SMEs, uptake was “probably raising less than £1 million in 2012, when it could reasonably have been expected to create a £16 million fund”.⁴⁵

There must also be doubts about the support climate for crowdfunding in Scotland. Unlike angel syndicates, crowdfunding projects cannot automatically call on co-investment funds. There may be a case for the Scottish Investment Bank to consider whether some form of co-investment might be extended to appropriate crowdfunded projects.

The successful crowdfunding campaign undertaken in February 2013 by Edinburgh company RunRev using the Kickstarter.com platform raised a total of £493,795, or 141% of its stated target of £350,000. The money was raised in 30 days from 3342 backers, the average pledge per backer being £148. This was not equity investment, but money contributed by backers motivated by RunRev’s vision of making available a free and open-source edition of its LiveCode software development environment, which it claims will enable anyone to write computer code.

Kickstarter.com is a platform designed to support the funding of creative projects across areas ranging from art and film through games to design and technology. At the time, the RunRev campaign was the largest technology fundraising to date through Kickstarter in the UK, although other campaigns have raised higher sums since.

⁴² FCA Policy Statement PS14/4; March 2014

⁴³ “FCA outlines crowdfunding rules”; Financial Times; 6 March 2014

⁴⁴ “Some simple economics of crowdfunding”; Agrawal, Catalini & Goldfarb; NBER Working Paper No. 19133; June 2013

⁴⁵ *Crowdfunding – The Scottish Perspective*; Report by twintangibles for Glasgow Chamber of Commerce; June 2013

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2.5 Corporate Venture Capital

Collaboration between large companies and SMEs can take on many forms, ranging from supply chain development relationships, through collaborative R&D, to corporate venture capital (CVC) investment. The term CVC encompasses a wide variety of models of equity investment by corporations in other businesses, specifically high-growth and/or high-potential private companies. A note on the subject published by the British Venture Capital Association (BVCA) in 2011⁴⁶ refers to the origins of CVC activity in the US in the 1960s, when large companies began to set up dedicated units to pursue strategic expansion initiatives. The BVCA note suggests that over the intervening period, a number of different approaches to CVC investment evolved:

- **DEDICATED CVC FUND:** the conventional approach in which a fund is established by the parent company as an external, arm's length entity. The capital allocated to the fund is invested in emerging high-potential businesses, typically in sectors considered strategically important to the future development of the parent. Examples: Reed Elsevier, BP, Unilever, ARM, Intel, Google, Bertelsmann
- **IN-HOUSE CVC INVESTMENT:** the use of resources and capital by the parent to develop within its own organisation research & development or other projects offering opportunities for diversification into new areas of business. The objective is to translate such projects into future drivers of growth for the parent. Examples: DMTG (Daily Mail Group), Procter & Gamble
- **EXTERNAL CVC INVESTMENT:** passive investment by the parent directly in minority stakes in other businesses, or investment in an external venture capital fund. Example: Telefonica

Subsequent work by BVCA in this area⁴⁷ offers a more sophisticated analysis of the evolution and current status of CVC investment. The BVCA guide outlines the history of CVC in terms of four distinct waves driven by different corporate priorities and environmental factors. It suggests that the most recent wave, during the period since 2000, has been characterised by an increasingly evolved environment in which the approaches of individual corporate investors have become more closely tailored to their specific structures and priorities. As a result, CVC activity is now better aligned with the overall corporate objectives of the parent company than tended to be the case in the past. CVC investment is also generally undertaken with a longer-term view, seeking to achieve a balance between financial performance (i.e. the direct return on the investment) and other strategic outcomes (for example, supply chain performance improvement or other developments which may improve the business environment for the parent).

Another variant of the CVC model is the operation by large corporates of incubators for new businesses. This became a feature of the dot.com era of the late 1990s/early 2000s, but subsequently fell out of favour. It appears to be making a return, however, particularly in certain specific sectors such as telecoms. Examples include Telefonica's Wayra, established in 2011 and now operating in fourteen centres in Europe and Latin America, and Deutsche Telecom's Hubraum, launched in Berlin in 2012.

⁴⁶ BVCA Research Note No. 14: An introduction to corporate venturing

⁴⁷ BVCA Guide to Corporate Venture Capital; 2013

Reference is frequently made to the tendency for large corporates to have built up substantial cash reserves over the period since the financial crisis of 2008. There is an expectation that, as a climate of greater confidence begins to return, a significant proportion of these reserves may be targeted at strategic growth and diversification opportunities through research & development, mergers & acquisitions (M&A) and corporate venturing. A May 2013 paper published by Deloitte⁴⁸ points out that the propensity of large companies to retain cash has not in fact been uniform – some have built up much greater balances than others. It notes that “current conditions of low valuations, inexpensive debt and record cash reserves all provide an environment conducive to dealmaking”, and suggests that “the markets are more rewarding of companies who are willing to take a bullish attitude towards growth and engage in M&A activities.”

It is worth pointing out in this context that whilst CVC and M&A activities are driven by similar broad objectives (e.g. innovation, diversification and growth), many companies view them as separate functions managed by different teams – sometimes well aligned to a common agenda, sometimes less so. M&A tends to have a considerably larger capital allocation, and to focus on relatively short term diversification and revenue growth; CVC is likely to be more speculative and to reflect longer-term product or market aspirations.

There has been a widely-held assumption amongst smaller emerging companies that corporate venture investment is almost inevitably a first step along the route to acquisition, closing off other potential exit opportunities. There is sometimes also a concern that it may narrow the range of market opportunities (for example, it may become difficult to do business with competitors of the investing company). Smaller companies may also feel vulnerable to misappropriation of intellectual property, or simply apprehensive at a perceived imbalance in negotiating strength.

Whilst most CVC investment goes into emerging companies in the same broad sector as the investor, or in areas of strategic interest, it is worth noting that investments are not always made with a view to later outright acquisition. Engaging with younger innovative companies can be valuable to large corporates for other reasons. It can offer a relatively low-risk route to exploring new directions, business models or potentially lucrative but unproven markets, or gaining practical insight into the use of emerging technologies. More experienced and enlightened CVC investors have tended to draw back from seeking preferential acquisition rights, understanding that they can establish mutually beneficial relationships with portfolio companies without limiting their exit options (and consequently possibly reducing financial returns).

As well as providing capital for young companies, CVC investment can offer them access to industry expertise, production capabilities and sales channels that could be costly and time-consuming to develop otherwise.

In some cases, CVC investors may effectively act as early-stage venture funds, making relatively small seed investments (perhaps of the order of £100k) in a range of opportunities, with a view to potential capital gain. More often, however, the focus is on more substantial investment (of the order of £1–2 million) in companies that are revenue generative and have the potential for significant growth. Corporate venture arms of global companies may develop a CVC model in one region and then replicate it across others.

⁴⁸ M&A Perspectives; Deloitte; May 2013

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CVC investors and conventional venture capital (VC) funds have rather different approaches and priorities, and thus tend not to operate together. There may be different views on valuation and on time horizon to exit, and some of the factors noted above in relation to company perceptions (e.g. exit options; narrowing of market opportunities) also represent concerns for VC funds. It is more likely that VC funds will seek to engage with the M&A teams in large corporates as potential acquirers of VC portfolio companies.

Healthy deal flow is as important for CVC investors as for any other type of venture investor. They are normally tightly focused on sectors of interest to them, and endeavour to build relationships that will give them sight of appropriate opportunities in these sectors. Nonetheless, with relatively small teams and often global environments to scan, maintaining high-quality deal flow can be a significant challenge.

Perhaps partly for this reason, there is some evidence that CVC investors are increasingly recognising common interests and collaborating with each other. For example, a joint initiative involving Cisco, DC Thompson and University College London saw the opening of the IDEALondon incubator in December 2013.

It is also interesting to note that the European Investment Fund (EIF), Europe's largest fund of funds investor, is experimenting with new types of relationships with CVC investors. EIF invests in venture funds across Europe, giving it access to a very large portfolio of VC-backed companies. It has established an initiative called the Corporate Innovation Platform (CoriP), a strategic investment programme focused on specific technology themes. CoriP co-invests alongside other seed investors, including business angels and family offices. It also offers large corporates a formal Engagement Model, giving them access to details of the Platform investors' deal pipeline with a view to identifying and pursuing co-investment opportunities. In turn, the corporates are expected to share market intelligence and technical expertise with the Platform investors. This is seen as being valuable to corporate investors in providing a pre-qualified deal flow from Europe-wide sources, offering an efficient and cost-effective means of identifying high-calibre opportunities.

The tax regime relating to corporate venture capital investment in the UK has arguably been somewhat out of step with the real environment over the past few years. The Corporate Venturing Scheme (offering tax incentives for corporate venture capital investment – in essence a corporate equivalent to the EIS personal tax incentives), was introduced in April 2000 with a proposed ten-year life. This ended on 31st March 2010, and the scheme was not extended. The total amounts invested under CVS were not high – over its lifetime, 579 investee companies raised a total of £132 million from 1003 investor companies⁴⁹. An average of just over £13 million per year could hardly be described as making significant impact. Over the final four years of the scheme, however, the amounts being raised annually showed a pronounced upward trend, and 2009–10 (the final year) saw the highest-ever level of CVS investment, a total of £28 million being raised by 80 investee companies. This was, of course, in the immediate aftermath of the 2008 crisis, when risk aversion might have been expected to be extreme and the propensity to hoard cash at its most pronounced.

⁴⁹ www.hmrc.gov.uk/statistics/cvs/commentary.pdf

The average level of individual investment under CVS was strikingly low, suggesting that the scheme was either not attractive to (or possibly not widely known amongst) large companies, or that the financial and economic climate during its life was not particularly conducive to its use. Public companies can, of course, only pursue corporate venturing activities in line with the aspirations of and authority granted by their shareholders, and this may also have been a factor. Since 2010, however, the environment has changed, and a scheme of this type might now give a more significant stimulus to corporate venture capital investment.

From a specifically Scottish perspective, the fundamental message is that globally corporate investors are active and have large amounts of money looking for high quality opportunities. They are likely to be particularly interested in companies that are already revenue generating, but some may also look at seed-stage investment. Their investment expectations and terms may sit more comfortably with business angels than do those of VC funds. However, in view of their highly individual priorities and areas of focus, it is unlikely that they would be attracted to invest in Scotland via any type of intermediary fund mechanism.

The key is, therefore, to ensure more visibility of our high-growth companies in this arena. There would seem to be a potential role for the Scottish Investment Bank in seeking to engage actively with CVC investors of particular relevance to its portfolio companies, possibly by considering an initiative along similar lines to the EIF's CoriP. Greater awareness of the existence and characteristics of CVC investment could also be promoted through relevant sector bodies (for example, Informatics Ventures), specialist media coverage and professional advisers.

2.6 Bank Lending

Commercial banks are not, at least in the context of their core operations, providers of risk capital. However, their role in the overall business finance infrastructure has changed significantly since the 2008 financial crisis, and this has impacted on the requirements and market for risk capital, so a brief discussion is relevant in the context of this document.

The recent Independent Lending Review chaired by Sir Andrew Large at the request of the Royal Bank of Scotland⁵⁰ estimated that since the financial crisis the overall level of bank lending to SMEs in the UK has declined by about a quarter. The report on the Review includes a comprehensive analysis of SME financing issues and their causes. This analysis suggests that the total stock of bank lending to SMEs during the period immediately preceding the crisis grew to exceed prudent levels, possibly by around 25% at its peak before the Bank of England base rate reductions in late 2008 and early 2009. This was driven by an abundance of cheap wholesale funding, competition between lenders and lax credit standards, and led to pricing of lending at levels that did not adequately reflect risk. As a result, SMEs were able in many cases to use debt finance for purposes which would more appropriately have been funded by equity.

50 RBS Independent Lending Review; November 2013 – www.independentlendingreview.co.uk

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Following the financial crisis, the banks confronted a range of priorities and pressures. Primary amongst these was the need to repair their balance sheets and service their own debt burdens. Their regulatory environment also became more stringent, and lending standards were tightened considerably. For these and other reasons, bank lending to businesses – particularly to those at the smaller and riskier end of the spectrum – reduced sharply.

The RBS Review report suggests that the level of bank lending to SMEs has now fallen to a level perhaps 15% below that which prudent lending standards would allow at current historically low interest rates. There are many possible explanations for this. There may still be a widely-held perception on the part of SMEs that bank lending remains so difficult to access that there is little point in trying. The experience of recent years may have created an exceedingly risk-averse mindset within the banks, for example amongst business banking relationship managers, that will persist for some time. It has also been suggested that there is a tendency for commercial banks to apply standard analytical approaches to widely varying types of businesses with very diverse characteristics and business models. This may particularly disadvantage emerging businesses with innovative products or business models.

A common characteristic of such companies is a lack of significant tangible assets to act as collateral against borrowing. Until 2008, the UK Government's Small Firms Loan Guarantee Scheme (SFLGS) was available to underwrite bank lending to companies which did not have sufficient asset backing. SFLGS was widely used by growing innovative technology and other companies, arguably sometimes prematurely, i.e. in situations in which companies barely had the capacity to service the debt. Partly in light of concerns that there had been some misuse of SFLGS, it was superseded in January 2009 by the Enterprise Finance Guarantee (EFG) scheme. The level of lending underwrite provided by EFG was, in some respects, less favourable to the banks than that offered under SFLGS, and some of the rules applicable to EFG were regarded during its early stages as ambiguous. For these or other reasons, the uptake of the scheme fell short of expectations. Total annual EFG-backed lending fell from £737 million in 2009–10 to £294 million in 2012–13, although seems set to show a moderate rise (possibly to around £350 million) in 2013–14. The extent to which this picture reflects subdued demand as against the quality of available lending propositions is difficult to discern.

Whatever the explanation, it seems clear that the role of bank lending in the financing of smaller companies has changed significantly since 2008. Tighter lending standards have led to a more rigorous view of the appropriateness of debt as opposed to equity funding, and the sharp decline in the availability of overdraft lending has meant that the use of debt to fund working capital requirements is not the option that it was in the past for many businesses. There is probably a need for a fairly fundamental re-setting of expectations and funding strategies on the part of emerging companies requiring growth finance, and equity investment seems likely to play a greater role.

2.7 The Role of Public Markets

A public stock market is not of itself a source of capital, but rather an intermediary between sources of capital and the companies that are admitted to the market. A brief discussion of the role of public markets is nonetheless felt to be relevant.

The existence of public stock markets dates back to the early 17th Century. They were a logical development of the concept of the joint-stock company, which emerged in the mid-1500s as a mechanism to enable an enterprise to be financed and owned jointly by a large number of unrelated proprietors, or shareholders. In 1602, the Dutch East India Company was the first company to issue shares that became tradeable on a stock exchange. This allowed the company to raise capital by selling shares to investors and subsequently provided investors with a market to enable the secondary sale or purchase of the shares and to establish, on the basis of supply and demand, a price at which these transactions would take place.

These remain the fundamental functions of public markets, such as those operated by the London Stock Exchange (LSE). They enable businesses to seek a listing for their shares or their debt, offering them to the public in a regulated environment, and they provide a secondary market for the buying and selling of shares, bonds and other instruments.

Over the last few decades, driven largely by the short-term perspectives of many investors and analysts, public markets have become less tolerant of business ups and downs, and the major stock markets are now only really suitable for large established companies with stable, predictable revenues and profitability. The ownership and funding of companies whose performance is less predictable (for example, because they are R&D intensive or are undergoing consolidation or restructuring) has increasingly been seen as the role of Private Equity investors.

Attempts to establish 'junior markets', supposedly with a greater appetite for risk, have not generally been notably successful in the UK and Europe. For example, the LSE Alternative Investment Market (AIM) was established in 1995 with less demanding listing criteria and more flexible regulatory requirements than those of the main market. Originally, the AIM market appeared to provide a useful service to companies in high-growth areas such as technology, clean-tech and biotech. However over the last ten years or so, many technology companies have left this market. For a time, there was a tendency for companies operating internationally in sectors such as mining to be attracted to join AIM by the liquidity and visibility of a quotation on a London market.

In August 2013, HM Revenue & Customs changed the rules relating to the management of Individual Savings Accounts (ISAs) (tax exempt savings vehicles available under the UK personal tax regime) to allow the shares of AIM-listed companies to be held by individual investors within an ISA. Whilst it is too early to draw conclusions on the impact of this, it seems likely to act as something of a stimulus to AIM.

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In general, the exposure of its shares to a public market tends to be problematic for any business which has yet to show a long track record of predictability and financial stability. It has been demonstrated that Scottish technology companies can achieve positive and reasonably consistent long-term share price performance on AIM if they can exhibit growth. If, however, their businesses are subject to significant fluctuations in financial results or perceived prospects, the market is likely to be very sensitive to this – and the resultant share price will experience considerable volatility.

The number of publicly-quoted companies has been decreasing for some years. For example, the number of UK companies listed on the LSE's main market fell from 1,931 in January 2000 to 1,270 in January 2007 and to 994 in January 2014. Over the same period, the number of UK companies listed on AIM grew from 351 in January 2000 to peak at around 1350 in late 2007, but has since declined to 860 in January 2014.⁵¹ This raises considerations relating to the range of opportunities and risk-spreading options available to investors through the public markets, and ultimately to the long-term viability of the markets. It is not easy to strike an appropriate balance between the need for regulation of public markets to provide investor protection and the risk of their becoming so rule-bound that their fundamental function in enabling businesses to raise capital is undermined.

There are parties (including major investors) to whom this is or should be a matter of concern, and who might be expected to see the emergence of more companies aiming for initial public offering (IPO) as being in their best interests. The London Stock Exchange has recently launched Elite, a business support programme designed to offer high-growth private companies guidance on shaping their businesses for long-term growth and increasing their attractiveness to potential investors. The first cohort of 19 companies participating in the Elite programme, announced in April 2014, includes two based in Scotland.⁵²

51 Source: London Stock Exchange statistics

52 "London Stock Exchange launches Elite Programme for high-growth companies"; LSE press release; 28 April 2014

3.0 Demand

As well as examining the supply side of the growth capital equation, it is also important to consider the demand side. A comprehensive analysis of the scale and characteristics of the demand for growth capital for emerging companies in Scotland is beyond the scope of this report, but some discussion of the topic is clearly relevant.

The discussion in Section 2.3.1 in the context of the scale of business angel investment referred to some of the inherent difficulties in obtaining reliable and comprehensive data on informal investment. For example, it involves essentially private arrangements with no requirement for public disclosure, and any publicly disclosed “headline” figures may not differentiate between elements of equity, debt and grant funding. These and similar factors can apply more widely to the whole field of investment in unquoted companies, giving rise to some challenges in assessing overall levels of activity, and consequently of demand.

There is also a sense that the demand for growth capital on the part of Scottish companies is to some extent conditioned by the nature of the sources of investment that are most immediately accessible, and by the infrastructure that exists in Scotland to advise and support companies seeking investment. There is a natural tendency for early-stage companies to focus their initial fundraising efforts on local sources, and possibly therefore to have their thinking influenced more by what they believe is realistically available from these sources than by what they actually require to achieve optimum outcomes. This can have impacts on both levels of ambition and allocation of management time and energy, which may have to be directed to a large extent towards obtaining the next funding round rather than the longer-term growth of the business.

It is also important to note that there are very significant sectoral differences in terms of the nature and scale of demand for growth capital. For example:

- In the broad field of software and IT, initial barriers to entry are now generally relatively low, and a “proof of concept” stage can often be reached with fairly modest capital investment. More major growth capital requirements are likely to arise at a subsequent stage to fund growth after technical feasibility has been demonstrated and some level of market penetration achieved. Regulatory compliance issues may arise from client requirements, but seldom lie at the heart of the business. There may be a significant creative dimension to software development, but risks tend to relate more to delivery timescales than uncertainty over the fundamental achievability of outcomes.
- The biomedical and pharmaceutical sectors operate in a highly regulated environment. A significant number of companies in this area are university spinouts and face the challenges arising from that background as well as the requirement to raise investment. Often, a primary objective is completion of regulatory processes which are an absolute pre-requisite to making any sales, but whose outcomes may be uncertain. For example, an adverse clinical trial outcome could call into question the entire future of a company. In some cases the end in view may be to license technology to a larger player rather than go directly to market. Capital requirements tend to reflect the need to make substantial defined commitments (eg. to undertake a clinical trial or complete a product certification process) which often have an “all or nothing” characteristic – i.e. funding for the entire process must be in place before it can be started. One consequence of this can be companies which spend considerable periods in limbo, burning the overheads involved in simply continuing to exist, but unable to take the next material step towards building value.

Demand

As regards quantitative data on the Scottish market, the publication Young Company Finance (YCF) has, over some fifteen years, built up a body of data on investment deals involving Scottish unquoted companies. Whilst YCF does not claim that its database provides absolutely exhaustive coverage of all such investment activity, it is believed to be the most comprehensive and reliable single source of data available. YCF data for the period since 2005 has been examined to try to build up an outline picture of the demand that it indicates for investment in emerging growth companies, as distinct from startup or seed-stage investment. A reasonable proxy indicator of this status was felt to be the raising of a cumulative total of £2.0 million or more of funding by a company during the period.

The YCF data identifies 125 companies which each raised funding amounting to a total of £2.0 million or more during the period 2005 to early 2014. The fundraising patterns varied very widely, from companies which raised sums into tens of millions of pounds in a single round to companies which raised a few million pounds over a number of rounds over several years. The backgrounds were also diverse, from management buy-outs of substantial existing businesses to small founder-led companies. As previously discussed, the available information depends to a considerable extent on voluntary public disclosure, and whilst the deals recorded are believed to involve mainly equity investment, elements of lending or grant funding may have been included in the “headline” numbers.

Over the period examined, the sample of 125 companies identified took in an overall total of approximately £840 million in a total of 407 separately-recorded funding rounds. The average total funding injection per company over the period was around £6.7 million, and the average single funding round was approximately £2.1 million. In the cases of 11 of the 407 funding rounds, the sum involved was recorded as “not disclosed”. In the majority of these cases, there appeared to be no reason to believe that the level of funding involved was such as to have a significant impact on the overall picture. In one instance, however, (the investment by Sequoia Capital in Skyscanner Ltd in October 2013) the sum involved is believed to be such as to warrant specific mention (see below).

Because the criterion for inclusion of a company in the sample was a cumulative fundraising total of at least £2.0 million, a proportion of the recorded funding is attributable to early and relatively modest seed-stage funding rounds into companies that subsequently went on to raise £2.0 million or more. The proportion of the recorded total that falls into this category is, however, small. A breakdown of total funding amounts according to round size (see Fig 3.1) indicates that individual funding rounds up to £0.25 million in size accounted for only £11.4 million (approx. 1.4% of the recorded total), and individual funding rounds up to £0.5 million in size accounted for £39.3 million (approx. 4.7%). By contrast, individual funding rounds in the range £2.0 million to £5.0 million accounted for £237.6 million, approx. 28.3% of the recorded total.

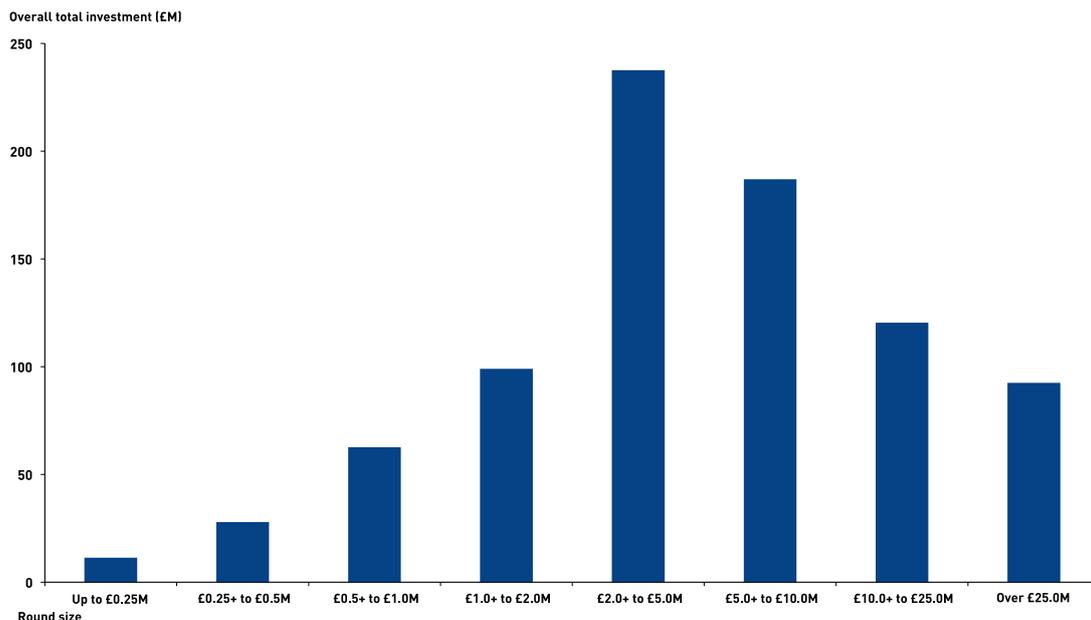


Fig 3.1: Overall investment amount by size of funding round

Source: Young Company Finance data

A breakdown of total funding by year (see Fig. 3.2) indicates a peak figure of £133.7 million in 2008, followed by fall of more than 50% over the subsequent three years following the financial crisis. Recorded annual totals then recover to £94.8 million (plus one undisclosed but very significant investment – see below) in 2013.

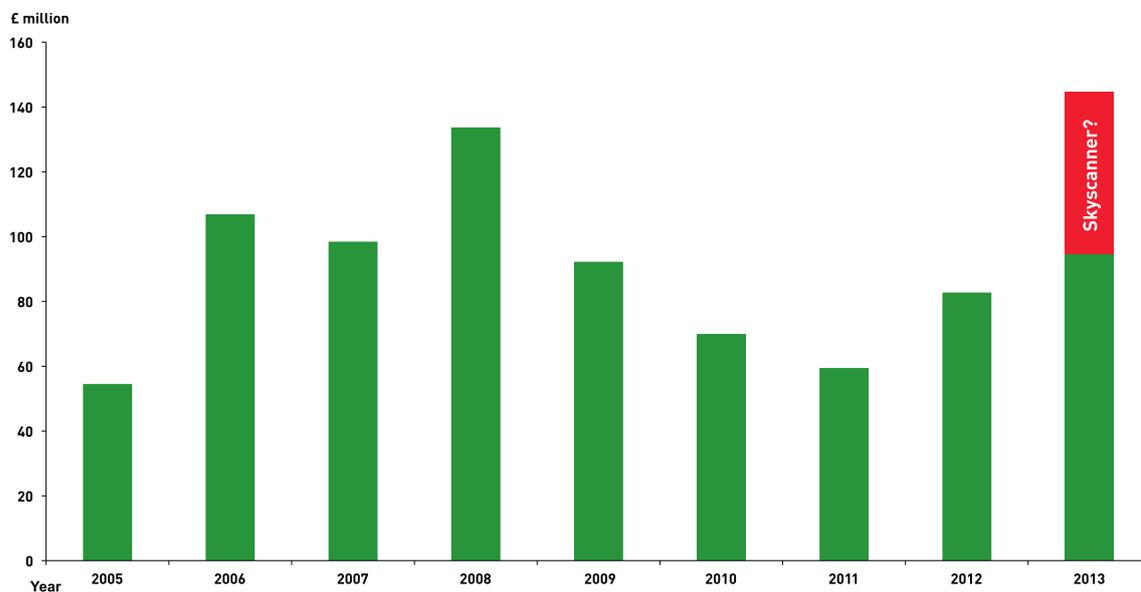


Fig 3.2: Annual funding totals recorded 2005 – 2013

Source: Young Company Finance data

Note: The probable significance of the 2013 investment in Skyscanner is illustrated by the inclusion of a separately-identified element based on an assumed value of £50 million – see main text.

Demand

Few emerging Scottish companies have raised total funding of the order of or in excess of £50 million within the last ten years. Amongst those which have done so were the Dundee-based computer games company Realtime Worlds, which went into administration in 2010, and the wave energy company Aquamarine Power, whose technology has been developed to full scale and is currently under test at the European Marine Energy Centre in Orkney.

Two recent investments in Scottish companies are also worthy of specific mention. In October 2013, it was announced that the prominent US venture capital firm Sequoia Capital had acquired a stake in Skyscanner Ltd., a fast-growing Edinburgh-based travel search engine company⁵³. Sequoia's investment was of an undisclosed sum, but was said to have been one of the largest it had ever made. It was reported to have valued Skyscanner at around £500 million. Unusually, it was described as a secondary investment, i.e. a transfer of ownership from existing shareholders rather than an injection of new funding into the company. For this reason, it could be argued that it falls outside the “growth capital” category. However, it is mentioned here in view of the magnitude of the sum believed to be involved and the international stature of the investor. The circumstances surrounding the investment and the reasons why it was made on a secondary basis are not in the public domain. There does not, however, appear to be any reason to believe that Sequoia would not in principle have been prepared to make such an investment as growth capital into the company if this had been considered appropriate by all the parties involved. Commentators suggested that Sequoia may have committed £50 million or more⁵⁴, probably the largest single investment yet made in an emerging Scottish technology company.

In April 2014, NuCana BioMed Ltd, an Edinburgh company involved in developing anti-cancer therapies, announced the completion of a US\$57 million funding round led by the California-based venture capital firm Sofinnova Ventures and involving other international investors⁵⁵. The company will use the funds to pursue clinical research programmes with a view to achieving regulatory approval of several of its lead compounds.

These two recent investments, as well as being notable for their size, should perhaps be regarded as encouraging confirmation of the capacity of Scottish companies of outstanding potential to attract investment on an international stage.

⁵³ www.skyscanner.net/news/skyscanner-partners-sequoia-capital

⁵⁴ “Skyscanner valued at £500M in new deal”; *The Scotsman*; 3 Oct 2013

⁵⁵ www.nucanabiomed.com/downloads/NuCanaFinancing2014.pdf

4.0 Recommendations

4.1 Venture Fund Attractive to Pension Fund Investors

There is a demand for investment in emerging companies which have demonstrated growth potential requiring funding beyond the scope of seed and early-stage investment (at the scale typically provided by business angels), or whose characteristics or business models are not compatible with angel investment criteria. The sums involved are, by definition, substantial and may be difficult for companies to find for a number of reasons, one of which is the apparent misalignment between the priorities and criteria of angel and VC investors.

Pension funds are seeking, in a difficult climate, to improve investment returns within acceptable risk parameters, and are also interested in reducing management overheads in their investment processes. Their minimum viable investment thresholds are high in the context of the growth venture market, and risk spreading is an important consideration. The most prized asset characteristics for pension funds are low risk and ability to deliver inflation-linked returns.

The question arises as to whether it might be possible to structure a venture fund of sufficient scale, efficiency and spread of exposure to play an effective role in funding the growth of emerging companies and also be attractive to pension fund investors. It is clear from the record of VCs' attempts to raise new funds in recent years that institutions are not at present naturally attracted to a conventional VC model, as discussed in Section 2.2.4. This leads to consideration of whether some public sector intervention could be warranted, not necessarily in contributing directly to the pool of investment capital, but rather in a catalytic role. This might, for example, involve supporting the costs of investigating the feasibility of such an approach, establishing an appropriate infrastructure for such a fund, or possibly providing some level of underwriting to give pension fund investors sufficient comfort to commit.

The UK Enterprise Capital Funds (ECF) model is clearly attractive to private sector venture investors, and has been effective in mobilising private capital alongside public sector investment in venture funds. It has done this by requiring that public sector investment receives a prioritised but relatively modest defined return, but accepting that, beyond that, the overall returns on the fund may be weighted towards the other investors. In effect, public money incurs less risk of loss, but accepts less potential for high returns.

A similar proposition might be attractive to pension funds, to whom a secure but relatively modest return (e.g. a reasonable risk-based premium over inflation-linked gilts) is probably more attractive than a more extreme risk/return balance. This might require a vehicle capable of:

- > deploying something of the order of £100 million per year or more of pension fund money;
- > doing so in such a way as to achieve an acceptable spread of risk;
- > paying its pension fund investors a prioritised yield, possibly somewhere in the range 3–5%;
- > offering its pension fund investors some participation in the equity growth of its portfolio, and doing so in such a way that earlier investors in the portfolio companies are not disadvantaged.

Recommendations

To achieve the scale of operation and spread of risk required, the remit of such a vehicle would probably need to be UK-wide. This is believed to be feasible under existing government structures. The situation in the event of a vote for Scottish independence would need to be reviewed and considered if and when the circumstances arose.

Various structures and approaches could be adopted by a vehicle of the type outlined above. For example, the preferred return to its pension fund investors could accumulate over a defined lifespan, and be returned as part of a distribution of capital at the end of the agreed period. This would reflect conventional VC practice, and is the approach taken by the ECF programme. This would direct the focus predominantly towards equity investment, and would look similar to, if larger than, the Enterprise Capital Funds.

Alternatively, the objective could be to generate a current income stream, as well as equity growth. This would probably be reflected in an investment proposition to emerging companies that would, in effect, involve a blend of debt (or some current yield mechanism) and equity. Approaches worth considering might include:

- > a combination of ordinary shares and bonds;
- > preference shares carrying a cumulative dividend right, but no or very restricted liquidation preference;
- > possibly an imaginatively designed convertible preference share structure.

Companies that would be receptive to such a proposition would by definition be sufficiently revenue-generative to be capable of servicing debt immediately, and possibly paying dividends from profits within a few years. This could suit the needs of certain types of companies (for example those that have demonstrated a consistent revenue generation record and require working capital for expansion rather than – or as well as – investment for further technology development). The element of liquidity that this approach would generate might be perceived by pension funds as attractive, in that it could go at least some way towards securing their preferred return. It might also help to create a viable “evergreen” structure, rather than a defined-life fund. This type of offering could be attractive to some companies that have simply outgrown angel funding, in that it could reduce to some extent the need to fund continuing expansion by equity.

It would not, however, generally be relevant to companies whose challenge is that they are fundamentally not suited to angel funding (for example, because their minimum projected requirements exceed angel capacity or due to time-to-market considerations). This latter category would be likely to include, for example, many biomedical companies – a sector of particular relevance to Scotland. These tend to be characterised by a more extreme risk/reward profile than most other early-stage businesses – the potential returns can be very high, but the levels of pre-revenue investment required are high and timescales can be relatively long. To achieve optimum impact in Scotland, and indeed optimum potential for returns, a large investment vehicle would ideally be capable of operating in the biomedical area. This would require the involvement of managers with extensive appropriate understanding and operational experience.

It might, therefore, be relevant to consider a fund structure which, whilst integrated at an overall level, involved a number of discrete elements focusing on specific types of businesses and categories of funding.

An issue of some significance would be the compatibility of a fund of this type with earlier-stage investment by business angels. The incompatibilities between the approaches of angel and conventional VC investors, and the resulting constraints on companies graduating readily from one to the other, have been the subject of a good deal of discussion. One outcome of this is a tendency for angel-funded companies to go to relatively early trade sale, rather than continuing to grow as independent businesses. In designing the operating model for any new fund, consideration should be given to this issue and how it might be addressed. For example, the use of a replacement capital mechanism (i.e. partial buyout of earlier investors) and restraint in the use of liquidation preferences might be elements of the formula.

Compliance with EU State aid rules would require careful consideration, although recent changes are believed to provide greater flexibility in the creation of vehicles along the lines discussed.

It is suggested that there could be a role for some appropriate private sector consortium, possibly with a degree of public sector support, to consider the establishment of a pilot fund of this type. Initial objectives might include:

- generating momentum by undertaking a feasibility study and meeting preliminary costs;
- investigating the nature and scope of underwriting that might be required to ensure that the risk profile of the fund could meet criteria acceptable to its pension fund investors.

The following possible roles for public support are suggested for consideration:

- supporting the costs of a feasibility study;
- supporting some element of setup costs;
- providing a contribution to management costs during the fund's early stage;
- providing an underwriting covering any defaults on dividend or interest payments and/or some proportion of any losses incurred. This could either work on a company-by-company basis within the venture fund portfolio or on a global basis, i.e. guaranteeing minimum returns to the participating pension funds. The underwriting could be provided on condition that the venture fund operated on an "angel-compatible" basis, if this were considered an essential characteristic.

4.2 Super Co-Fund

The Scottish Co-investment Fund (SCF), established in 2003, was something of a pioneer in the area of private/public co-investment in early-stage businesses. It invests on a *pari passu* basis with its accredited partners, many of whom are business angel syndicates. The partners act as lead investors, and SCF relies on them for due diligence and negotiation of terms. Its model has been recognised and replicated internationally. In 2012, the UK Angel Co-fund was set up along broadly similar lines with an initial capitalisation of £50 million, subsequently increased to £100 million in 2013.

Recommendations

A concept that might be worthy of consideration and evaluation would be the extension of the co-investment model by the addition of a further tier drawing on institutional investment. The principal source would probably again be pension funds, but such a model might also be of interest to a broader range of institutional investors and perhaps to others, for example certain family offices.

In principle, a “Super Co-fund” might be established by inviting institutional investors to match the combined seed (usually angel) plus public sector Co-fund investment on a *pari passu* basis at some appropriate ratio, the details of which would need to be determined by consultation between all the parties involved.

It is relevant to note that the European Commission has recently amended and clarified the State Aid rules relating to co-investment of risk capital by the public sector. The Commission’s guidance refers to a “market economy operator test” based on the principle that “economic transactions which are carried out by public bodies or undertakings in line with normal market conditions and do not give rise to an advantage to their counterpart do not constitute State aid”. Transactions effected jointly on a *pari passu* basis by public and private sector investors are deemed to conform to these criteria.⁵⁶

The “Super Co-fund” concept would have the following characteristics and advantages for the parties involved:

- It could feasibly operate as an “evergreen” fund.
- It could offer institutional investors the possibility of investing alongside successful business angel syndicates on *pari passu* terms in companies which had progressed beyond seed stage and had an established market presence and a credible trading position. They would therefore be substantially de-risked by general business angel standards.
- Whilst conventional VC firms have struggled to deliver positive returns in this market in recent years, the Kauffman/Nesta research shows that successful business angels can and do generate strong positive returns. Important factors in achieving this performance are the domain experience, general business experience and connections that business angels can bring to bear, and the time which they are willing to commit as non-executive directors and advisers to portfolio companies.
- An accredited lead partner model would mean that management costs could be much less than those involved in managing a conventional VC fund. This would, of course, depend on the existence of an accreditation system regarded as convincing by institutional investors. This approach would avoid the need to create an expensive fund structure, although clear guidelines would be required to deal with eligibility, investment criteria, conflicts of interest and so on (these issues have already been addressed in the Angel Cofund). There could be an initial charge to the fund for each investment, all subsequent monitoring and non-executive director fees being payable by portfolio companies.

⁵⁶ Communication from the Commission – Guidelines on State aid to promote risk finance investments (2014/C 19/04); Official Journal of the European Union; 22 Jan 2014

- It would be necessary for the fund to access a range of opportunities and achieve a spread of risk commensurate with the scale needed to be viable for institutional investors. For this reason, it is felt that exposure to the whole UK market would be more attractive than an offering restricted to Scotland.
- The Scottish business angel market is, however, characterised by more developed and longer-standing business angel syndicates than the English market, which has evolved with less formal networks. The Scottish angel syndicates would be likely to be well placed to make use of a new source of capital along the lines proposed, which would offer the prospect of:
 - Increasing investment capacity at the level of £2 million and above in a single deal, widely seen as a crucial gap.
 - Stimulating early stage M&A activity and thus helping to consolidate the market position of high-potential technology and other businesses, and also helping to re-cycle angel investment capital.
 - Strengthening balance sheets, thus helping companies to secure appropriate levels of debt finance from conventional banking and asset finance sources.

The new British Business Bank and the Scottish Investment Bank could be approached to investigate their views on such an initiative. Again, the situation in the event of a vote for Scottish independence would need to be reviewed and considered if and when the circumstances arose.

As noted above, implementation of this idea is not seen as requiring a separate fund structure, but a set of rules and guidelines, probably drawing to a considerable extent on existing experience of co-investment structures. Funds would be drawn down from institutional investors as required and returned on exits.

An appropriate fund administration and accounting system would be required, but the overall cost would be much lower than that of running a conventional fund and there would be no requirement to pay carried interest or equivalent. Should such an initiative be seen as worthy of detailed evaluation, the first step would be to work up a detailed proposal and produce an information memorandum for discussion with prospective institutional investors.

4.3 Use of Venture Capital Trust Vehicles

Another initiative worthy of consideration would be the use in Scotland of Venture Capital Trust vehicles to attract additional retail investment into the emerging company market. There is, of course, nothing new about this concept and indeed it arguably runs counter to the trend for VCT offices to move away from Scotland, as discussed in Section 2.4.2. It seems unlikely that existing VCT managers would readily incur the costs of re-establishing bases in Scotland.

Recommendations

Relatively high management fees are sometimes cited as a disincentive to investing in VCTs. Consequently, any practicable approach to reducing costs would be worth examining. For example, it might be feasible to develop a VCT that would partner with angel syndicates, relying on them to lead on due diligence, investment terms and oversight of portfolio companies. The potential advantages of such a relationship have been outlined in the Super Co-fund proposal above, and this approach might enable a VCT to adopt a relatively “light-touch”, and consequently low-cost, management approach. There would, of course, be a certain irreducible overhead involved in ensuring compliance with regulatory and HMRC requirements.

An interesting model is to be found in the Titan VCTs managed by London-based Octopus, one of the leading VCT managers in the high-growth technology sector. Since 2007, five successive Octopus Titan VCTs have raised a total of over £100 million, and they currently hold a combined portfolio of just under 40 unquoted companies. Investments are managed by an in-house team in conjunction with Octopus Venture Partners, a network of more than 100 successful entrepreneurs and business angels who can, and regularly do, co-invest with the VCT. Octopus works closely with individual members of its Venture Partner network, who will typically chair the boards of portfolio companies and represent the interests of investors. It believes that access to this body of additional expertise gives it a strong competitive edge in the marketplace. Octopus has a sizeable sales force targeting independent financial advisers and other relevant channels throughout the UK. This infrastructure represents a key factor in enabling it to raise funds, although obviously also a significant cost.

It is suggested that:

- An approach should be made to enquire whether Octopus would consider taking a more active approach to the Scottish market, recruiting more individuals based in Scotland into its Venture Partners community and seeking to pursue opportunities for investment in high-growth companies in Scotland.
- The attitudes of other selected VCT managers to a similar proposition should be investigated.
- Any other possible approaches to establishing a low-overhead VCT, as outlined above, should be considered and evaluated.

4.4 Access to Corporate Finance Advice

The availability of high quality corporate finance advice is an important element of the environment to support high-potential companies. This is relevant from the startup stage, to try to ensure that all funding possibilities are considered and that early decisions do not constrain future options. It is suggested in this context that the resources currently available to early-stage companies in Scotland are relatively limited and expensive. Consideration could usefully be given to improving access by young companies at realistic cost to the fairly sophisticated level of advice relevant to high-potential businesses.

ICAS is working with the other professional accountancy bodies (the ICAEW and ACCA) and the UK Government on a new service, the Business Finance Advice Scheme. This service will help businesses to find advice on obtaining finance from qualified accountants that deal with SMEs on a regular basis and have the skills and experience to help. Accountancy firms that are members of the scheme will be able to provide advice on business plans, business start-ups, small-scale equity issues and bank loans and overdrafts.

Consideration could be given to extending this type of approach into more specialised areas relevant to high-growth businesses. Initiatives in this direction would be worthy of encouragement. It is, for example, an area to which the new British Business Bank might direct some attention.

4.5 Infrastructure to Engage With Investors Outside Scotland

For a significant number of companies, the most relevant sources of investment may lie outside Scotland, and in some cases outside the UK. Significant resources are required to research and engage with specialised investors internationally, and this is a challenge even for reasonably-established companies. Consideration could usefully be given to strengthening the infrastructure available to support Scottish companies in researching and addressing international investment markets. A more developed and co-ordinated body of knowledge of and contacts in such markets could improve efficiency and minimise duplication of effort.

ANNEX 1

WORKING GROUP MEMBERS

Ian Ritchie OBE, FREng, FRSE (Chair)	Entrepreneur & Investor; Vice-President (Business), Royal Society of Edinburgh
Andrew Barrie	Founder and former CEO, Barrie & Hibbert
Sandy Finlayson	Senior Partner, MBM Commercial LLP
Chris Fletcher	Formerly KPMG, Baillie Gifford; Director, Northern 2 VCT plc; ICAS Business Policy Committee
Owen Kelly OBE	Chief Executive, Scottish Financial Enterprise
Heleen Kist	Independent Consultant/Director; Non-Executive Director, Capital for Enterprise; Member, Access to Finance Expert Group, Department for Business, Innovation & Skills; Chair, Scottish Health Innovations Ltd.
Keith Neilson	CEO, Craneware plc
Todd Nugent	Director, Noble Grossart; ICAS Business Policy Committee
Graeme Sands	Regional Director, Business Expansion & Execution, Clydesdale Bank
Sarah Smart	Formerly Investment Director, Standard Life; Chair of The Pensions Trust; Board member, London Pensions Fund Authority; adviser to the Lothian Pension Fund
Executive:	
Gordon Eadie	Independent Director & Investor; Member, Royal Society of Edinburgh Business Innovation Forum





The Royal Society of Edinburgh
22 – 26 George Street
Edinburgh
EH2 2PQ

T 0131 240 5000

F 0131 240 5024

E rse@royalsoced.org.uk

W www.royalsoced.org.uk

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