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PROCEEDINGS OF SEMINAR: THE GROWTH CAPITAL MARKET FOR EMERGING COMPANIES IN SCOTLAND

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Participants

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Introduction

The Royal Society of Edinburgh (RSE), Scottish Financial Enterprise (SFE) and the Institute of Chartered Accountants of Scotland (ICAS) have co-operated on a recent examination of the market for growth capital for emerging Scottish companies with exceptional potential and requirements for substantial levels of investment to realise that potential. A joint Working Group, whose membership represented a broad range of financial sector and business experience, was established in 2013 by the three organisations to address this topic The Working Group's report, *"The Supply of Growth Capital for Emerging High-potential Companies in Scotland"*, published in June 2014, is available at: www.royalsoced.org.uk/cms/files/advice-papers/2014/AP14_06.pdf

Emerging dynamic young companies are often seen as an important wellspring of future economic success. The creation of new companies has been a major economic development priority in Scotland for some twenty years, and the environment for business startups has improved significantly during that period. Arguably, however, there are still challenges to be met in mobilising sources of substantial risk capital for companies with the potential to go on to achieve truly significant scale.

Access on a progressive basis to appropriate funding is a critical factor in enabling high-growth businesses to realise their potential. In this context, the joint Working Group considered aspects of the Scottish growth capital environment including the roles of business angel, venture capital, retail and institutional investment markets. It noted, for example, the eminence and economic importance of Scotland's institutional investment community, and observed that, for a variety of reasons, it has very little interaction with the risk capital market referred to above. The Group considered ways in which that interaction might be stimulated to the benefit of both constituencies and the wider economy. It suggested the creation of new investment structures which might address the need for capital to support companies with requirements for substantial levels of funding to realise major growth potential.

This is complex territory, and the formulation of constructive and viable outcomes will depend on greater engagement and understanding between a number of key constituencies. It is nonetheless felt to be a topic of considerable importance to Scotland's economic future.

This seminar was arranged in the hope of achieving a number of objectives:

- To re-focus attention on the topics covered by the Working Group's report.
- To update on relevant developments since publication of the report.
- To make connections and provide an opportunity for exchange of views and experience.
- Above all, to stimulate action.

It involved a limited number of participants, listed above, who were invited in their personal capacities, recognising the specific expertise and experience that they as individuals brought to the discussion.

Opening statements

Three of the participants were invited to make opening statements summarising their individual perspectives and experience, to set a context and provide a basis for subsequent discussion.

Jamie Coleman, CEO, Codebase

Codebase is a business incubator for early-stage informatics companies. It currently hosts around 60 such companies. Its value proposition is rooted in the community and environment that it has created, offering access to expertise and experience in areas including technology, management, market engagement and investment.

Its existence and approach are underpinned by a belief that software is a core asset and driver of virtually all growth businesses. For the first time in history, most people have access to communications technology – specifically the internet, which is now accessible throughout the world to more people than have street addresses or mains electricity supplies. In this context, growing companies with the potential to make a significant global impact face the fundamental challenge of scaling their accessibility, functionality and load capacity from supporting hundreds of users to supporting hundreds of millions of users.

Codebase believes that Scotland's educational and research base and its business startup environment are conducive to the creation of new companies with substantial potential. The history of an increasing number of companies, for example Skyscanner, Fanduel and Rockstar North, provides evidence that such businesses can grow to global scale from a Scottish base.

It has been estimated that investment into European and Israeli informatics companies is running at a rate of approximately US$590 million per month, and that the ratio of comparable investment to GDP in the USA is higher. Historically, the growth patterns of such companies tended to show a high proportion of their growth occurring post-IPO (eg. Amazon). This has now changed, a higher proportion of overall growth occurring pre-IPO (eg. Facebook, Ali Baba).

In recent years the Venture Capital sector in Scotland has to a large extent withdrawn from investment in early-stage companies. Codebase has noted, however, that over the last few years around 50 new business angel and VC groups have been established in the Republic of Ireland (albeit with very significant government intervention).

Sinclair Dunlop, Managing Partner, Epidarex Capital

Epidarex is an early stage venture capital house with a specific focus on the life sciences sector. Its first UK-focused fund, which closed in 2013, attracted total investment of £48 million from a variety of sources including the endowments of four Scottish universities, the European Investment Bank, the Scottish Investment Bank (on behalf of Scottish Enterprise) and Strathclyde Pension Fund. The pharmaceutical company Eli Lilly is also an investor.

The establishment of Epidarex was based on the premise that the Scottish venture capital market in the life sciences sector is under-supplied, and therefore has the capacity to attract additional venture investment from international sources.

The technology base underpinning the life sciences sector in Scotland is primarily located in research institutions, predominantly universities. The quality of research capability in and outputs from Scottish institutions are now considered to be very high (for example, Edinburgh University is now regarded in terms of research capability as being within the top 5 universities in the UK, the top 10 in Europe and the top 20 globally).

Epidarex would characterise itself as operating at the second stage of the funding escalator. In its environment, this would typically see it investing in companies immediately after the completion of the process of technology transfer from a research institution, possibly having been supported by a limited amount of prior seed investment. At this point the technology involved is normally at a pre-clinical stage and the company is still some way from generating revenues. A funding injection of the order of at least £2m to £5m is typically required to reach the next significant milestone in building value in the business.

It was noted that at this stage in the development of a life sciences company, the approach to company building is now often "virtual" in nature rather than conventional. Teams are now more likely to include a number of part-time roles, enabling the company to access specific expertise and inputs to the extent required, but on a basis commensurate with the resources available.

Epidarex considers the availability of investment at the stage beyond its current focus and capacity to be a significant challenge for companies of the type represented in its growing portfolio, and by extension for the life sciences sector in Scotland. For example, in the field of drug development, funding of the order of £15 million may be required take a single drug candidate from laboratory to the clinic (ie. to the beginning of the clinical trials process – progress beyond that to market requires funding of a different order again). Access to finance on a progressively increasing scale is a vital (although by no means the only) characteristic of an environment conducive to the growth of successful life sciences companies of significant scale.

In this context, acquisition by large pharmaceutical companies has historically represented an exit route for investors in many early-stage drug development companies. Large pharmacos are currently becoming more active in seeking such acquisitions. Public markets are also beginning to open up, after a period of relative inactivity, as a potential avenue for such companies.

Andrew Barrie

Andrew Barrie was a member of the joint RSE/SFE/ICAS Working Group responsible for the report referenced in the Introduction. He has since been consulting widely with representatives of the financial and early-stage business communities about possible approaches to improving the growth capital environment.

One of the key challenges in doing this is matching the characteristics and requirements of the demand and supply sides of the equation. The other two opening statements both referred to the importance of scalability and access to follow-on investment to enable growth. Even on the basis of these statements alone, the potential demand for growth capital would appear to be of the order of some hundreds of millions of pounds per year. However, there is a need to analyse and package this demand in such a way as to present investment opportunities perceived as compelling by major institutions.

The RSE/SFE/ICAS Working Group focused on seeking private-sector solutions to these challenges, and on approaches to mobilising more capital from private sector sources. Any approach to doing this must be based on a clear understanding of

i) the existing environment and support infrastructure for early-stage businesses, and

ii) the characteristics and criteria by which institutional investors would judge the attractiveness of any new vehicle designed to operate in this area.

It would be vital to ensure that any new initiative would work with existing players (eg. business angel syndicates, early-stage venture funds, business incubators, etc.) to enhance the overall environment and improve performance and investment returns across the entire sector. A number of questions arise, for example:

- What would need to be done to change the landscape in Scotland within the next ten years to attract capital at levels of £50m and above per single institutional commitment and mobilise it in investment in emerging high-potential companies?
- What criteria would a vehicle (or vehicles) designed to do this have to meet, and what would its (or their) operating structure(s) look like?
- How would such vehicles fit within the portfolios of the institutions investing in them?
- What type of governance regime would be appropriate?

The existing private equity investment sector has been facing a number of issues over recent years. Major institutions have in general moved away from venture capital and private equity as an asset class, for a number of reasons, eg.:

- returns have been disappointing.
- management costs have been perceived as excessive; the conventional 2+20 management fee model (2% fee on funds under management + 20% of capital gains) has been questioned by institutional investors.
- the illiquid nature of the underlying assets can cause concerns.

One model which is, however, seen as warranting further examination is that adopted by Imperial Innovations. This is a public limited company established in 2006 as a vehicle for commercialisation of intellectual property created from the research base of Imperial College, London. Imperial Innovations' current venture fund has £400 million under management, of which £300 million has been invested to date. It regularly co-invests with other sources of funds, and the net impact has been investment totalling around £1 billion into its portfolio companies. Over its lifetime, its share price has outperformed most public market indices. Neil Woodford, a prominent UK fund manager, has directed funds into Imperial Innovations as a direct channel to investment in the outputs of one of the UK's premier sources of technological innovation.

Imperial Innovations is listed on AIM, providing a market in the company's shares and thus access to liquidity. It nonetheless seems to have managed to reconcile the short-term perspectives that tend to characterise public markets with the longer-term view that best matches the inherent performance of its underlying assets and thus its own strategy. It does not appear to operate a "star manager" culture, but rather to rely on the blend of relevant experience and insight that its team can bring to bear collectively.

At around 2%, its cost base is relatively high (certainly by comparison with targets being set by government for pension fund management costs - in the region 25-50 basis points). However, a significant element of this cost base relates to the structuring of scalable companies to achieve optimum commercial outcomes from the original intellectual property.

Scotland has traditionally had strengths in the management of investment trusts, and these could possibly be applied to the creation of a vehicle with objectives similar to those of Imperial Innovations. It was however noted that the expectations and environment that have grown up around Imperial differ from those surrounding conventional investment trusts. For example, Imperial typically trades at a 60% premium over net asset value, whereas investment trusts typically trade at a discount to net asset value. An initiative of this type in Scotland might be able to partner with and draw on elements of existing infrastructure, and in doing so maintain a relatively efficient cost base – perhaps nearer 1% than 2%.

The geographic focus of any such vehicle would need to be considered carefully. The Scottish market alone would at present be unlikely to provide sufficient scope of opportunity and spread of risk, so a wider geographic range would be necessary. The question of sectoral spread, and access to the expertise necessary to support this, would also be a fundamentally important consideration.

The challenges in realising a vision of this type would include:

- bringing to bear relevant investment knowledge and experience in designing and implementing it.
- refining the proposition to align it most effectively with the realities of investment opportunities, relationships with strategic partners, regulatory requirements, etc.
- seeding the process.

Discussion

In discussion of the issues raised by the three opening statements, the following matters were covered:

There was some discussion of the balance between supply and demand in the investment market for early stage companies in Scotland. Differing views were expressed in response to the question of why Scottish VCs have become less active in local early-stage deals. It was suggested that quality of opportunity in the available deal flow may be a factor. However, availability of funding was felt to be a constraint – one view from within the investment community was that there are enough high-quality investment opportunities to deploy probably three times the amount of capital currently available. The allocation of funds in the early-stage investment market generally (angels and smaller VCs) is at present very heavily weighted towards follow-on investment in existing portfolio companies rather than in new companies. There was apparent consensus on the point that the demand for follow-on investment is extremely high, and that consequently companies requiring their first injections of seed investment are experiencing considerable difficulty.

A number of points were made with respect to the perceptions and attitudes of large institutional investors to venture capital as an asset class. These included:

- the view that the timing of exits from individual investments by VC funds can be sub-optimal. Exits tend to be driven by the life of the fund (typically ten years) rather than by holding them to a point of "natural maturity" which might enhance shareholder returns.
- the issue of capital calls by VC funds on institutional investors, which may require the institutions to sell other assets at a sub-optimal time.
- Concern over the possibility of significant cash "drag", ie. the holding over considerable periods of large cash balances on which management fees are charged.

Reference was made to the conventional approach to early-stage investment in Scotland, which typically involves a succession of small investment rounds rather than few large rounds. One consequence is that the behaviour of companies seeking investment tends to be conditioned by this environment – their aspirations and plans are built around the funding constraints which they expect to experience, rather than the resources required to realise their potential as fully and quickly as possible.

It was noted that, in the overall context of this discussion, a fundamentally important factor in attracting investment is a convincing record of growing companies from early-stage to businesses of substantial scale. If this is achieved in any sector or geography, investment capital will follow. The creation of this type of "virtuous circle" clearly depends on access to investment at a level required to prime the process in the first place. It is also, however, heavily dependent on a number of other factors – notably, availability of the kind of management expertise and experience necessary to direct and drive company growth.

It was suggested that, from an investor perspective, the profile of the early-stage investment market in Scotland differs from that in the rest of the UK. For example, there is relatively more emphasis on university spinouts in Scotland than in other parts of the UK, and there are also differences in sectoral focus (possibly reflecting the areas of strength in the Scottish university research base).

Scotland has a long-established and well-developed business angel investment infrastructure. It was however noted that the population of high-net-worth individuals in Scotland is relatively small – there are, for example, only 13,000 additional-rate taxpayers in the country. Also, there appear to be fewer cashed-out entrepreneurs active in its angel community than is the case in some other parts of the world (notably Silicon Valley). This may be reflected in perceptions and understanding of investment propositions and in attitudes to risk. A misalignment of interests between business angels and venture capital investors (arising to some extent from the EIS rules for angel investors) has been cited as a constraint on funding the growth of companies beyond the seed and early stages. It was suggested that this may not in fact be as fundamental and intractable an issue as has sometimes been proposed – there are ways in which angel and VC investment can be structured to work together satisfactorily.

The investment trust structure mentioned by Andrew Barrie was seen as worth considering as a vehicle through which to channel investment into the unquoted growth capital market. Investment trusts tend to be more suited to the retail investment market than to institutions, primarily because they are generally traded at a discount to net asset value. The question of liquidity may also be of some concern to institutional investors. Management costs can be an issue for investment trusts, which have to operate at some scale to be viable.

There was some discussion of the history of the Venture Capital Trust sector in Scotland – in particular, the question of why VCT activity in Scotland has apparently diminished over recent years. It was noted that the UK government has recently announced plans to limit the age of companies eligible to receive investment under the EIS and VCT schemes. This will have an adverse impact on VCTs that have focused on relatively more mature companies, whereas those that have focused on earlier-stage companies may be better positioned in the future. The largest VCT established to date is believed to have received investment amounting to about £200 million.

It was pointed out that even the higher end of the scale of investment under discussion is still relatively small from the viewpoint of pension fund and institutional investors. Few pension funds will put in the requisite due diligence and governance work for investments of the order of a few millions, or even a few tens of millions, of pounds. It was suggested that institutions would seek to invest in any new vehicle at a minimum level of about £50 million, and would wish (or require) their holding not to exceed 10% of the overall size of the fund. This gives an indication of minimum viable scale, suggesting that the geographic focus of such a fund would have to be UK or Europe-wide rather than limited to Scotland.

It can be challenging to convince pension funds that the managers of venture funds operating in the technology area have the understanding and expertise necessary to provide the required level of comfort. Notwithstanding this, it was noted that money from pension funds in Scotland does almost certainly find its way (usually under a heading of "alternative asset" allocation) through intermediary vehicles into early-stage companies in other geographies, for example California.

A number of comments were made with respect to criteria that would have to be considered in establishing any new investment vehicle intended to attract institutional money:

- There would need to be complete clarity on what it was trying to sell and how it would create value for its institutional investors.
- The track record of the team involved would need to be credible. In the first instance, it would clearly be unlikely that there would be any collective track record. However, a new team of experienced and credible individuals could provide sufficient comfort.
- Institutional investors are interested in investing in what they perceive to be under-competed spaces. They are also wary of the risk of fuelling a bubble in a market which begins to attract increased attention. If, for example, the life sciences sector in Scotland were to be seen as a currently under-competed investment market, the lack of a bubble would be a selling point.
- It was suggested that interested parties could be invited to commit some capital to the establishment of a structure, on the understanding that they would have substantial capacity to co-invest in the opportunities that it subsequently generated.
- On the matter of management and oversight, it was suggested that there would be two possible approaches. One would rely to a considerable extent on existing infrastructure (eg. angel syndicates and early-stage VCs) to qualify and manage investments, the new vehicle itself co-investing with relatively light oversight. The other would see the new vehicle establishing its own intensive due diligence and oversight capacity.

- Reference was made to the experience and approach of certain existing players (eg. Octopus, which draws on the expertise of a network of experienced angel investors alongside a Venture Capital Trust structure). It was suggested that to manage a fund adopting this type of approach with a light (ie. merely administrative) oversight capacity would be very inadvisable.

There was some discussion of the international perceptions of the quality of the Scottish research base, as encountered by Epidarex in raising its fund. This had not been an easy sell to investors, who tended to focus particularly on the processes and practices for transferring technology into new companies. On the other hand, there was recognition of the quality of opportunities likely to be available to a new fund entering an under-supplied market.

Reference was made to the proposal that Imperial Innovations should be considered as a model. While the Imperial story is interesting, it was pointed out that other organisations have been established with broadly similar objectives, one such being the IP Group, established in 2001 and floated as a public company in 2003. Its market capitalisation is now believed to be in the region of £1 billion. It was suggested that further evaluation of the overall experience and performance of organisations of this type would be worthwhile, and should draw on as wide a base of evidence as possible.

The proposition that pension fund and institutional investors should be seen as the primary source of capital for a new investment vehicle was questioned. It was suggested that family offices and private wealth managers might be at least as important as potential sources of funds. Improving understanding of and links into the corporate venturing community was also proposed as a worthwhile objective.

The question of achieving greater aggregation of investment by business angel syndicates (along similar lines to approaches being taken by crowdfunding aggregators) was also raised. Some existing web-based operators (eg. Syndicate Room) appear to be aiming to do this.

It was suggested that early-stage Scottish companies seeking equity investment need to extend their horizons to a greater extent. Given its status as a global financial hub and its relative proximity, London is an obvious centre to which to look. Companies seeking investment in London need to be able to meet with potential investors face-to-face, and a facility in London which Scottish companies could use as a base for this purpose could play a valuable role.

The view should however also extend beyond the UK – improving contacts with relevant investors internationally should be seen as an important objective. It was noted that there has been a tendency to expect public sector agencies to do this, whereas it should be seen as a more widely-shared responsibility.

It is however important to bear in mind that international venture capital investors prefer to invest alongside (indeed, they often require) a credible local lead investor. The existence of a strong local growth capital investment infrastructure also sends to international investors a significant message about scope and quality of opportunity.

Postscript

It is interesting to note that late April 2015 saw the closure of subscriptions to a new investment trust whose portfolio will consist of early-stage and early-growth quoted and unquoted companies. Its specific focus will be on businesses which are commercialising innovative technologies and have strong intellectual property positions.

The Woodford Patient Capital Trust, managed by Woodford Investment Management (WIM), originally set a fundraising target of £200 million. In early April 2015, in response to demand, it raised this to £800 million, and even at that level was oversubscribed. This set a new record for a London-listed investment trust. WIM indicated that it expected the trust to be fully invested within one to two years.

This outcome is clearly partly a reflection of the strength of the Woodford reputation, and the fact that WIM has made such a commitment to this area of investment is of itself seen as significant. It would however also appear to provide evidence of a substantial underlying appetite for investment in the equity of emerging high-potential companies of the types discussed in this document and the precursor work.

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