STIMULATING THE PROVISION OF VENTURE CAPITAL WITH PUBLIC FUNDING : THE UK EXPERIENCE

Background

The UK Government has been investing public funds to support the Venture Capital (VC) industry in the UK since the late 1990s. In addition to this direct investment activity, the UK Government provides tax reliefs to individuals to invest through funds (Venture Capital Trusts) and directly (Enterprise Investment Scheme). This paper focuses on funded interventions rather than tax reliefs.

Unlike less mature VC markets, the UK Government has not needed to invest to stimulate the creation of a VC industry. The UK has had a viable and active VC market since the establishment of the Industrial and Commercial Finance Corporation (ICFC, later 3i) in the 1940s. That market has developed rationally with investors gravitating towards those investment opportunities which, in aggregate, offer the highest and/or most stable financial returns. Historically those investments have been in leveraged buyouts and larger development capital deals and institutions have increasingly backed funds investing in those areas. The gravitation of capital towards these deals has left a shortage of capital to meet the needs of viable, smaller innovative companies. This shortage is commonly referred to as “the equity gap”. Since 2003 this gap has been considered to be “structural”, i.e. the fundamental economics of small deals in higher risk companies will always fail to deliver the returns available from investing in larger, more stable businesses.

UK Government believes there are significant economic benefits to be gained from investment in smaller, innovative companies and is prepared to invest to ensure such investment continues to take place. In the belief that every £1 invested will generate more than £1 of economic value[1], the Government also sees the benefit of leveraging in private funding to this sector of the VC market and has been prepared to structure its investments in such a way as to provide an incentive to private investors to invest alongside it in the “equity gap”, even if that increases the chances of the public investment being “lost”.

The UK Government also sees considerable benefit from engaging with private investors because of the disciplines that private investors can bring to the monitoring, management and commerciality of the investment programmes developed. It is acutely aware of the risk of political distortion, however unintentional, that Government can be perceived to bring to corporate investment.

In order to attract private investment, Government has sought to provide the minimum incentive necessary to attract private capital. It has introduced a number of programmes over the years, each with differing objectives and each therefore with a different structure of incentives. The main programmes are listed in the table attached, along with details of their size, whether the Government investment is subordinated and the leverage generated.

[1] defined as the benefits from increased turnover, employment, exports, productivity etc’

Experience

In reality, a complex matrix of the structure of Government investments has developed. The type and degree of subordination of Government investment tends to be driven by:

- the severity of the restrictions placed on the investment mandates (often defined by size and driven by EU Competition rules),
- the types of investor targeted (institutions or HNWI[2]s, financial or philanthropic) and their current appetite for this investment class,
- the stage of investments targeted (seed, start-up etc'),
- the ability to build a large, diversified portfolio of investments through a fund-of-funds vehicle,
- the stage of the investment cycle (vintage year) the programme is introduced
- the existence of a Global Financial Crisis (GFC)

and this list is not comprehensive!

Summary and Questions

Design of the structure of Government investment to address equity gaps is never going to be easy. It will always depend on the state of the development of the individual national, or sub-national market and an assessment of the factors above. Much of that assessment will be predictive and subjective, in particular, estimating what returns might be available from any investment programme and hence the degree of subordination required to encourage the investors to choose to invest alongside Government rather than in alternative opportunities.

There are also other hazards to be considered. One is the effect of the existence of a subordinated investor on fund managers. If a manager believes that one of the investors in his fund is seeking a reduced, or even negative return, will he maintain his investment discipline and only seek the best investment opportunities?

There is also too little evidence yet of the economic impact or economic return of funds investing in the equity gap. Even in the UK, over 10 years experience has still not generated sufficient data to be able to make a robust assessment of returns to the economy (because the highest returns from investments are still "prospective"). Given the length of these time horizons, it could be a considerable act of faith for any Government to continue investing over decades, let alone to continue an investment programme of a predecessor Government.

With an increasing acceptance that all VC investment, outside of a few select super-funds, has failed to deliver on expectations, the absence to date of new, more efficient and effective VC investment models and the lack of evidence of wider economic benefit, it must be questioned also whether Governments can continue to fund such activity in a period of austerity.

[2] High Net Worth Individuals

Fund Programme	Fund Type	Gov't Commit ment	Private commitm ent	Leverage public: private	Status of Government commitment	Investment Restrictions
Current Programmes						
Enterprise Capital Funds	Public/Private VC funds investing in the equity gap	£156.2 m	£81.3m	~1:0.5	Priority return at Gilt rate, then suppressed profit share	Yes, maximum investment £2m
Aspire Fund (Investing in Women-led businesses)	VC Co-investment Fund	£12.5m	>£12.5m	1:>1	Parri passu	No
Office of the 3rd Sector (Cabinet Office)	VC Fund investing in social enterprises	£5m	>£5m	1:>1	Parri passu	Yes. Sectoral
UK Innovation Investment Fund	Fund-of-fund structure GFC Response Measure	£150m	>£175m	1:1.2	Parri passu	No (except "innovation" and some sectoral targets)
Legacy Programmes (no longer making new investments or loans)						
Capital for Enterprise Fund	Fund-of-funds providing growth capital GFC Response Measure	£50m from BIS	£25m	1:0.5	Parri-passu	Yes. Maximum investment £2m
Regional Venture Capital Funds	**9** VC Funds	£74.4m	£250.5m	1:2.4	Subordinated preferred	Yes. £500k maximum investment and regional
UK High Technology Fund	Early stage Technology VC Fund of Funds	£20m	£126.1m	1:5.3	Subordinated	No (except technology and expectation of earlier stage)
Bridges CDVF	VC Fund investing in deprived areas	£20m	£40m	1:1	Part subordinated	Yes. Geographical and State Aids
Early Growth Funds	**6** Venture Capital Funds and a Mezzanine Fund	£31.5m	£63m (min)	1:>1	Parri-passu	Yes. c£200k investment size and normally co-investment