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The Department for Business, Innovation and Skills

Venture capital support to small businesses

Summary

1 Since 2000 the Department for Business, Innovation and Skills (the Department), and its predecessors, have provided venture capital funding to support young, often highly innovative companies that find it difficult to raise finance through conventional means. The Department believes such companies have significant potential to stimulate economic growth and productivity through developing new ideas and technologies.

2 Start-up companies are often perceived by potential investors as risky, because of the initially negative cash flows and high chances of failure. Limited collateral and trading income mean that conventional loans are not usually available to such companies. Equity support, whereby the investor accepts a share in the ownership of the company, is the most usual type of financing for start-up companies but external provision is limited. Departmental consultations show this equity gap is most acute for businesses seeking between £250,000 and £2 million because of the inherent riskiness and disproportionately high cost of managing these investments and as a result potentially viable business ideas do not receive support.

3 Since 2000, the Department has placed around £337.9 million in a series of venture capital funds aimed at supporting small businesses seeking equity investment (**Figure 1**). Other investors have contributed a further £438.2 million, making a total of £776.1 million potentially available. The funds are administered by private sector fund managers who are responsible for making investment decisions, offering businesses in receipt of funding the technical and managerial expertise needed to help them grow and for managing the portfolio of investments over the cycle of the fund's life.

4 Until April 2008, the work of the fund managers was overseen by officials in the Department. In April 2008 the Department established Capital for Enterprise Limited as a wholly-owned company to deliver finance measures in support of small businesses, including oversight of the venture capital funds programme. The Department remains responsible for advising ministers on policy in this area.

5 This report examines the venture capital funds established by the Department since 2000, in particular:

- the role and development of venture capital in providing equity finance and why businesses may be unable to obtain equity finance (Part 1);
- the performance of the equity funds against the Department's objectives (Part 2); and
- the management of the programme and individual funds by the Department and Capital for Enterprise Limited (Part 3).

Figure 1
The Department's venture capital funds

Scheme name	Objectives	Year commenced	Fund sizes[1]	Government commitment	Maximum investment
UK High Technology Fund[2]	• Demonstrate to investors and the venture capital industry that commercial returns can be made on early stage, high technology investments. • Attract new institutional investors into the technology sector and encourage their longer term interest.	2000 – fund-of-funds 2000 – five underlying funds 2001 – three underlying funds 2002 – one underlying fund	£126.1m	£20m	No limit
Regional Venture Capital Funds (RVCFs)	• Establish a programme of regionally based venture capital funds where the majority of investment is provided by the private sector. • Demonstrate to potential investors that commercial returns can be made by funds investing in the equity gap such that future funds could have less Government subordination. • Increase risk capital to growing small businesses without displacing other activity in this part of the market.	2002 – seven funds 2003 – two funds	Individual funds range from £12m-46m Total raised £226.5m	£74.4m	£500,000
Community Development Venture (Bridges) Funds	• Provide venture capital to commercially viable businesses that operate within or have links to the 25 per cent most under-invested (disadvantaged) areas of England.	2002 – two funds, A and B	A) £28m B) £12m	A) £14m B) £6m	A) £500,000 B) no limit
Early Growth Funds (EGFs)[3]	• Demonstrate to private investors that commercial returns can be achieved by investing in early growth businesses. • Encourage risk funding for start-ups or early growth businesses.	2002 – one fund 2003 – two funds 2004 – three funds	Individual funds range from £3m-£5m Total raised £91m	£26.5m	£100,000
Enterprise Capital Funds (ECFs)	• Increase flow of new fund managers entering the early stage market. • Attract more entrepreneurial investors to the market. • Be a self-financing programme over the medium term.	2006 – five funds 2007 – one fund 2008 – two funds	Individual funds range from £10m-30m Total raised – £205m	£134.5m	£2m
The Aspire Fund	• Increase the number of successful women led businesses within the UK. • Act as beacon to women entrepreneurs, where they can demonstrate high growth potential. • Improve linkages between sources of funds and providers of investment readiness support.	2008 – one fund	£12.5m May raise up to £25m in co-investment	£12.5m	£1m

Figure 1

The Department's venture capital funds *continued*

Scheme name	Objectives	Year commenced	Fund sizes[1]	Government commitment	Maximum investment
Capital For Enterprise Fund[2]	• Support viable businesses, enable them to raise new long-term finance and take advantage of business opportunities even in difficult trading conditions. • Support businesses that find it difficult to finance their current business plans, where the business is over-leveraged.	2009 – fund-of-funds, two underlying funds	Individual funds £30m plus a co-investment provision of £15m Total raised – £75m	£50m	£2m

Source: National Audit Office

NOTES
1. Fund size relates to amounts committed by the Department and other investors or raised through co-investment, and not to current valuation. Co-investment is explained in paragraph 1.10.
2. The primary role of a fund-of-funds manager is to invest in other funds offering support to businesses meeting the Department's criteria.
3. This Figure and the amounts shown in paragraph 3 exclude a hybrid Early Growth Fund which incorporates debt and equity options to which the Government has committed £5 million.

Findings

6 The Department failed to establish a robust framework of objectives, and associated baselines, to enable it to judge whether the taxpayers' investment offered value for money. The Department has set multiple aims for each fund but these have not been translated into clear measurable objectives or prioritised. With the exception of the Enterprise Capital Funds no clear financial objective was set for the impact of the funds to the taxpayer, such as whether they were expected to break-even and over what timescale, and the Department did not specify objectives for wider economic benefits apart from the Bridges Funds. There is evidence of informal learning between fund launches but the Department has not put in place a structured process to measure performance against its objectives. In late 2008 the Department commenced an interim evaluation of the economic benefits of the Regional Venture Capital Funds and Early Growth Funds. The evaluation focuses on the net economic impact of the funds but will not provide robust evidence to measure achievement of all of the stated objectives.

7 Business groups, businesses and fund managers report that start-up companies face an equity gap and that public funds have an important part to play in addressing that gap. Eighty four per cent of businesses surveyed by us for three of the funds reported that the initial funding had made it easier for them to obtain additional finance from other sources. Without support, most of those who would have proceeded anyway would have delayed their plans or reduced the scale of their activity. Publicly supported venture capital was not the only source of funding available to these start-up companies. Thirty two per cent of businesses reported they would have been unable to obtain any finance without support from the funds. Around 23 per cent reported that they would not have gone ahead with their planned activity in the absence of finance from the Department's funds.

8 The financial performance of the Department's early funds is likely to be poor, although not untypical when compared to private venture capital returns over the same period. Venture capital funds are a long-term investment with negative cash flows until typically the eighth year of the cycle. We looked only at the interim financial performance of funds more than five years old, as the venture capital industry considers it is reasonable to begin to evaluate the financial performance of funds from this point. As the Department's funds still hold a significant number of investments the final performance of the funds at the end of their lives is uncertain. Similar cohorts of private venture capital funds have performed poorly in Europe over the last decade compared to previous periods. We found:

- *UK High Technology Funds.* The pooled interim rate of return across the nine underlying funds in June 2008 was minus 9.7 per cent (net of fund management costs), with only one of the nine funds showing a positive rate of return. Comparable private technology funds show a pooled average return of minus 5.2 per cent at that date.
- *Regional Venture Capital Funds.* The pooled interim rate of return across the nine funds at December 2008 was minus 15.7 per cent with all nine funds showing negative returns. Private funds of a similar size and vintage (time of establishment) show a return of minus 0.4 per cent but are subject to fewer investment restrictions.
- *Bridges Funds.* The pooled interim rate of return at September 2008 was plus 7.7 per cent. The fund has fewer constraints on its investment activities than the Department's other funds, notably its ability to invest in property. The interim rate of return has fallen from a peak of 17.4 per cent reflecting the economic downturn and the decline in the value of its property-backed assets.

9 The performance of the Regional Venture Capital Funds was impeded by their design. Recent academic research identifies a number of factors which tend to improve the chances of a successful venture capital fund, including a flow of good quality deals; the timing of investments; broad geographic coverage; larger fund sizes; and the ability to make follow-on investments and to exit individual investments on a timely basis. In the light of this research the Regional Venture Capital Funds suffered limitations against all of these criteria to varying degrees. The pool of viable business propositions targeted by the funds was restricted in some cases by investment criteria, for example their regional focus and the total allowable investment limit for a business was £500,000, which restricted the size of initial and follow-on investments.

10 The taxpayer is unlikely to receive returns on investment in the early funds, but should be better protected in future through recent improvements in fund design. Earlier funds were designed to protect other investors in the event of poor financial performance, to encourage them to invest alongside the Government. Based on valuations at 31 March 2009 the Department's Accounts currently value the £74 million invested in Regional Venture Capital Funds at £5.9 million, and the Department will only get a return if the individual funds outperform the preferential 10 per cent return to other investors. The Enterprise Capital Funds, launched in 2006, strike a better balance between protecting the taxpayer and encouraging other investors to participate because the public sector is the preferential investor, while private investors have greater opportunity to benefit from success.

11 The fee rates paid by the Department to fund managers have been comparable to the wider venture capital industry but over the lifecycle of the funds, depending on the eventual returns achieved, this is potentially an expensive form of business support. The remuneration structure reflects private sector fund management practices in percentage terms and basic salaries paid to fund managers are at the lower end of the industry scale. Businesses in receipt of support reported that they had, in most instances, benefited from the expertise of their fund manager. Over time the cost of administering the funds can, however, represent a sizeable percentage of the amount invested. By 2008 the cumulative costs paid by the investors in the UK High Technology Fund and underlying funds totalled £19.5 million (17 per cent of the amount invested); Regional Venture Capital Funds £46.1 million (36 per cent of the amount invested); and Bridges Funds £7.7 million (29 per cent of the amount invested). The funds were initially expected to last 10 to 12 years but the life can be extended with the agreement of investors. The severity of the current economic downturn suggests the funds are likely to run for some years yet before the investments can be successfully realised. The cumulative cost figures will therefore increase further.

12 The creation of Capital for Enterprise Limited has the potential to strengthen oversight of the funds. The new Board at Capital for Enterprise Limited brings with it a significant range and depth of relevant experience. Our work suggests there is a clear division of responsibilities within the programme between the Department, Capital for Enterprise Limited and fund managers.

13 To date the Department has published virtually no information on the performance of the funds. The National Audit Office's analysis published in this report is the first time that information about fund performance has been made public. This partly reflects concerns over maintaining commercial confidentiality and is in keeping with practices adopted for Government venture capital interventions overseas. It is unclear, however, how keeping this information confidential helps the Department demonstrate to private investors that commercial returns can be made from investing in the equity gap – one of the original aims for the early funds. There is a case, therefore, for greater transparency balancing the legitimate needs of private investors against those of taxpayers.

Conclusion on value for money

14 Businesses in receipt of publicly-supported early stage investment have reported positive outcomes, for example that the funds have offered them much needed finance not easily obtainable from other sources and that this has allowed them to raise other finance and to grow. But the Department did not set clearly specified, prioritised objectives for its funds, nor did it establish baselines against which it could judge what it was getting for taxpayers' money.

15 The performance of the earliest funds suggests the Department is unlikely to make a positive financial return or recover all of its investment. The Regional Venture Capital Funds have particularly poor financial performance to date in comparison to other types of funds, with a pooled interim internal rate of return of minus 15.7 per cent and cumulative management fee costs of £46.1 million representing 36 per cent of the total value of investment. Improvements have been made to the design of the Enterprise Capital Funds to strike a better balance between protecting taxpayers' interests and attracting other investors.

16 In the absence of a robust measurement framework, and given the poor performance of the early funds to date, the Department agrees with our conclusion that the programme cannot currently demonstrate value for money. The Department is, however, putting in place steps so that it is better able to demonstrate value for money through strengthening its programme management and evaluation, in particular setting clear and measurable objectives and baselines for those more recent funds which are still open to investment. The following recommendations are designed to reinforce the Department's work.

Recommendations

17 We make the following recommendations:

a **The Department's objectives for its funds are not precisely defined.** The Department should define more clearly the objectives for each of its funds and the criteria against which it will evaluate whether these objectives are being achieved. These objectives should include a financial objective for each fund specifying the extent to which taxpayers' money is expected to be recovered and the timescale over which this will happen.

b **The cumulative cost of managing a total of 28 different funds all with broadly similar objectives will over time add up to a significant proportion of the money invested.** Capital for Enterprise Limited reports the cost of establishing and managing some but not all funds to the Department, and should extend this to all funds to ensure that the Department's decisions are fully informed. Although to date no extension to the life of a fund has been requested, Capital for Enterprise Limited should take this cost into account when considering any future requests to extend the life of existing funds and negotiating the terms of any extensions. The Department should also evaluate the costs and benefits of each of the fund models it has used to date so that it can be sure that the most efficient model, at a fund size which takes advantage of economies of scale, is used in future.

c **The validity of the Department's current investment approach is not yet demonstrated through successful exits of businesses from funds.** Fund success is crucially dependent on spotting and supporting a small number of high growth businesses. The Department should evaluate whether the current approach is likely to optimise performance. Factors influencing success which could be analysed in any future exercise to design new funds include the size of individual funds, the pattern and scale of investment, the criteria used to decide the size of pool of ideas from which investments will be chosen and the merits of each of the fund models tried to date.

d **Over time a range of fund types have been established with a number of similar aims, but the Department has not viewed the funds as a programme.** The Department should begin to manage those funds that are currently investing in businesses as a programme and outline how the various elements fit together. Capital for Enterprise Limited should draw together existing information covering all individual fund types so that the Department has a more complete overview of how they fit together. The Department should then put in place a framework for evaluating the programme of funds building on the work it started in evaluating the early funds. Such an evaluation would allow the Department to undertake more informed policy making in terms of understanding the cost effectiveness of the interventions in the context of other measures to support small businesses.

e **There is little information about the funds in the public domain.** To increase transparency, the Department could make more information about the funds publicly available. While this need not include confidential or sensitive financial data, it could include breakdowns of public and private sector investment to date, geographical and sectoral analyses of where investments are being made and details of successful exits and write-offs. The Department should also consider how best to raise awareness amongst potential beneficiary companies, for example, by promoting successful businesses in receipt of its funding.