Capital for Enterprise Ltd: Overview of publicly-backed venture capital and loan funds in the UK

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OVERVIEW OF PUBLICLY-BACKED VENTURE CAPITAL AND LOAN FUNDS IN THE UK – EXECUTIVE SUMMARY

The Government identifies a market failure in the supply of equity finance to small and medium sized enterprises (SMEs). Both the current Coalition Government and Governments that preceded it have sought to address this market failure through a range of schemes. In the past, investments into these financial interventions have not always been joined up. As a result, the landscape is complex and information is fragmented. Over the past decade or so over one billion pounds of UK Government money has been invested in a range of schemes alongside a further billion pounds of private money and over £500 million from the European Regional Development Fund.

This report contains a very high level quantitative and graphical overview of publicly-backed venture capital and loan funds (VCLFs) in the United Kingdom. It is designed to raise awareness of publicly backed VCLFs and is the first stage in a series of reports covering in increasing detail the activity and performance of publicly backed funds.

Key points to note are:

- Since 1999, more than 150 publicly backed funds have been established totalling more than £2.7 billion in commitments from all investors. This £2.7 billion comprises £1.1 billion of UK Government money (from various departments/agencies), £1.1 billion of private investment and 0.5 billion from the European Regional Development Fund (ERDF)
- The landscape is incredibly varied ranging from small microloan funds of£1 – 2 million to large funds of funds of £200 million
- Almost 70 funds comprising £1.6 billion in commitments are in their investment period (this includes “evergreen” funds). This £1.6 billion is made up of over £0.6 billion of UK government money, £0.6 billion of private money and more than £0.3 billion of ERDF
- Of the £1.6 billion commitment to funds which are still investing, three fifths is committed to funds with a regionally constrained investment policy
- £1.4 billion has been invested into 65 funds with vintage years from 2009 and 2011
- The most significant players have been the Regional Development Agencies (RDAs), the Department for Business Innovation and Skills (BIS) and the Devolved Administrations (DAs) in Scotland and Wales, and to a lesser extent Northern Ireland

CfEL overview of publicly backed funds in the UK

1. Background

The Government accepts that there is a market failure in the supply of equity finance to small and medium sized enterprises (SMEs). Both the current Coalition Government and the Governments that preceded it have sought to address this market failure through a range of schemes. The Department for Business Innovation and Skills (and its predecessor departments) has established a range of national programmes (sometimes with a regional focus) such as Enterprise Capital Funds, Early Growth Funds and the UK Innovation Investment Fund. The Regional Development Agencies (RDAs) and Devolved Administrations (DAs), often utilising money from the European Regional Development Fund, have established SME finance interventions designed to tackle the particular needs of that country or region of the UK. Although often focussing on equity finance, many of these schemes have also sought to provide loans and microloans. Finally, some other government departments have also established venture capital and loan funds often focussed on a specific policy area. So for example, the Department for Energy and Climate Change (DECC) established the Carbon Trust Fund investing in clean technology businesses.

Over the years, these various policy objectives have led to an increasingly complex landscape of publicly-backed venture capital and loan funds. The information is now being brought together by Capital for Enterprise Limited (CfEL). CfEL is the UK government's Centre of knowledge and expertise on the design, implementation and management of SME finance interventions. The information is still fragmented and work needs to be done to develop a common assessment framework across funds.

This report contains a very high level quantitative and graphical overview of publicly backed venture capital and loan funds in the United Kingdom. It is designed to raise awareness of publicly backed venture capital funds and is the first stage in a series of reports covering in increasing detail the activity and performance of publicly backed funds looking at both the financial return/cost to government and the wider economic performance – the jobs created, the gross value added etc.

2. Data limitations, interpretation and coverage

The landscape is complex and the data can be cut in a number of different ways. Even apparently simple questions such as "How many funds are there?" require one to make certain value judgements in order to provide an answer. For example, one funding allocation for a microloan fund might be sub-contracted to five different lenders. One could legitimately view this as one fund or as five funds. Conversely a single lender or fund manager might receive two separate funding allocations. These might be considered as two separate funds, or as two investments or grants into a single fund. Rather than attempting to impose some form of national consistency, issues such as this have been treated according to local custom. In the case of funds employing a holding fund structure such as the JEREMIEs[1], the number of funds shown in this report is the number of underlying funds

[1] Joint European Resources for Micro and Medium Enterprises

investing in Small and Medium Enterprises (SMEs). For example, in Yorkshire and the Humber the JEREMIE fund has three sub-funds and this figure is reflected in the analysis.

Another common inconsistency is in the treatment of management fees. In a typical limited partnership, management fees are paid out of the total fund commitment. In other funds, particularly those part funded by the European Regional Development Fund (ERDF), there is often a separate fee allocation on top of the capital commitment. In this report, where there are separate commitments for fees and capital the amounts shown only cover capital commitments.

This report provides a near complete view of publicly backed funds making new investments, but it is not fully comprehensive. Notable exclusions include the evergreen University Challenge Seed Funds founded in 1999-2000 (except in cases where an RDA has also invested in the fund). The data on publicly backed funds managing out their portfolios is a less complete. The report covers all funds historically under CfEL oversight. That is:

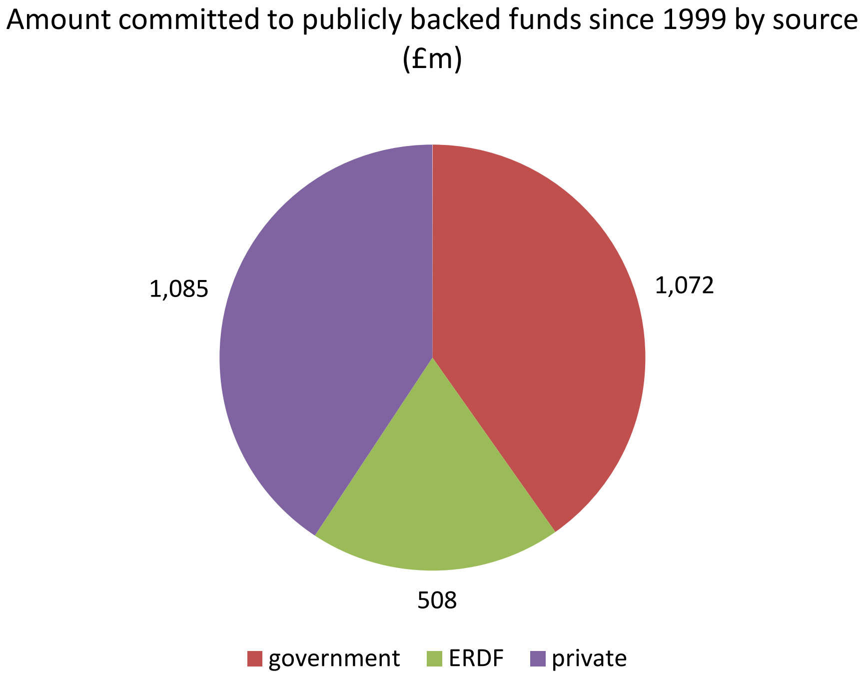
- The UK High Technology Fund
- 9 Regional Venture Capital Funds
- Community Development Ventures Funds
- 6 Early Growth Funds
- The Accelerator Mezzanine Fund
- 10 Enterprise Capital Funds
- The Aspire Fund
- The Capital for Enterprise Fund (3 funds)
- 2 UK Innovation Investment Funds
- The Angel CoFund

The report aims to cover all venture capital and loan funds (both investing and those in their post investment period) into which Regional Development Agencies have granted or invested money from the single programme and most Community Development Finance Institutions (CDFIs) that received money from RDAs post 2006. It also aims to cover all funds that have received ERDF funding, even if these did not also receive any single programme funding. Finally, the report includes those funds invested by Other Government Departments (OGDs) and Devolved Administrations (DAs), but does not include all legacy funds established by these organisations.

3. Total number of publicly-backed funds and sources of funding

Since 1999, around £2.7 billion has been committed to over 150 funds. The true numbers will be higher because, as noted in the previous section, these figures do not include legacy funds in Scotland and Northern Ireland, or the full suite of University Challenge Seed Funds established in 1999.

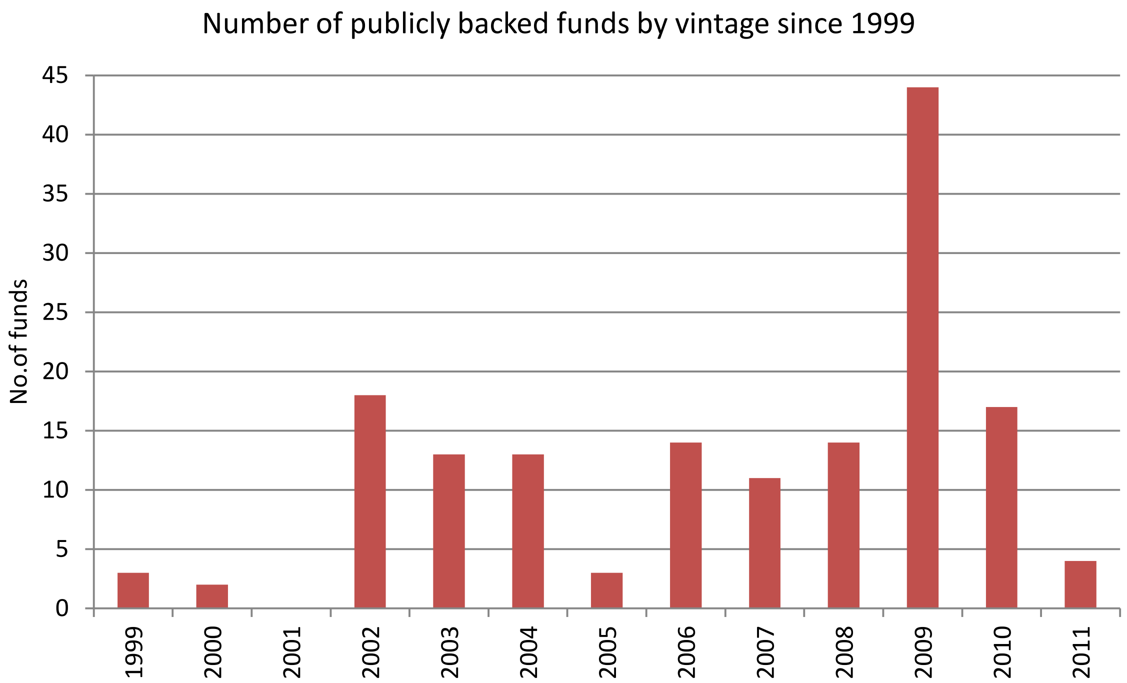
In terms of commitment, the £2.7 billion breaks down as £1.1 billion of UK government money (in its various guises), £510m of European money[2] and £1.1 billion of private money. The largest single private investors are the European Investment Bank and the European investment Fund, these organisations having committed more than £400m between them. Other private investors include banks, pension funds and private individuals.



[2] Mainly European Regional Development Fund (ERDF), but also a small amount of European Social Fund (ESF)

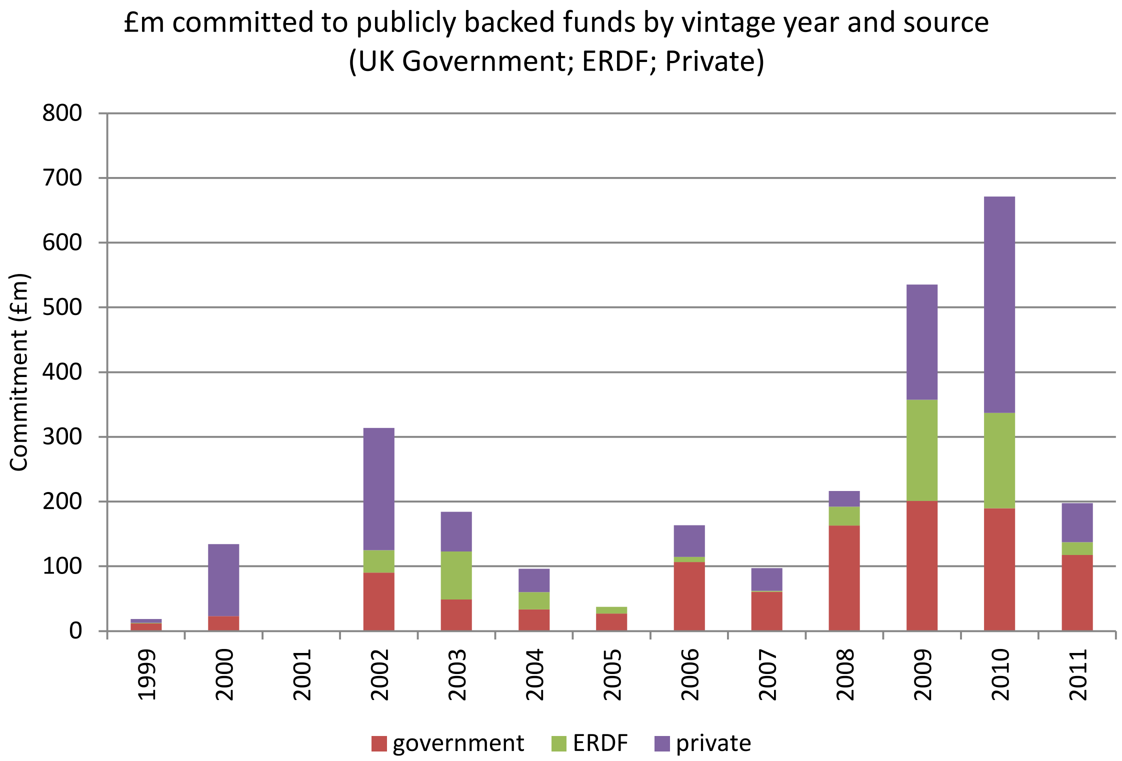
4. Funds by vintage

The chart below shows the number of publicly backed funds launched in the UK in each year since 1999.



The pattern of peaks from 2002 to 2004 and 2008 to 2010 reflects the availability of money from the European Regional Development Fund (ERDF) 2000-06 and 2007-13 programmes respectively. In 2002 the picture is compounded by the launch of the Regional Venture Capital Fund programme. In 2009, national directives in the wake of the "credit crunch" coincided with the availability of new ERDF money. Following the example of Advantage West Midlands in creating a Transition Loan Fund, the Secretary of State for Business Innovation and Skills encouraged all the other RDAs to create similar funds. These were launched in 2008 and 2009. The peak in 2006 is primarily due to the launch of the first wave of Enterprise Capital Funds in that year.

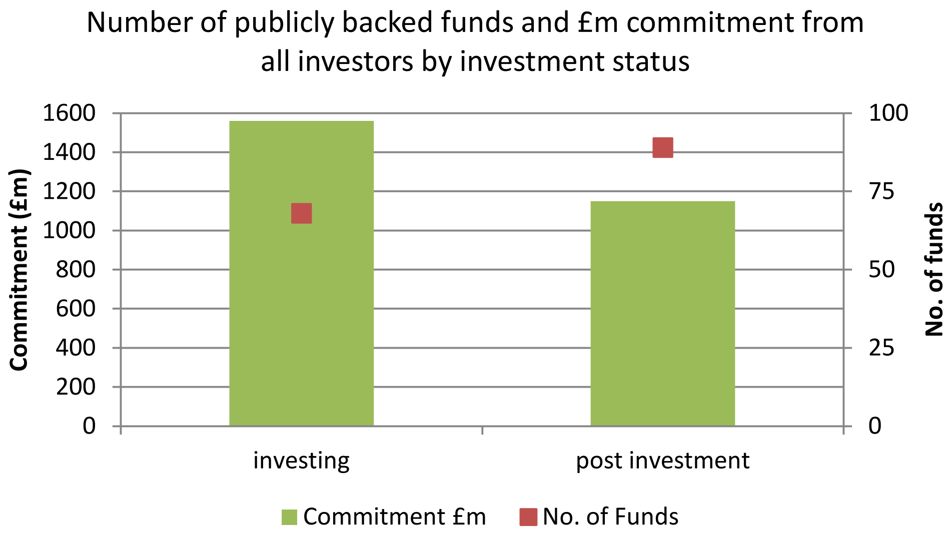
The following chart shows the total commitments by all investors to publicly backed venture capital funds by vintage year and source of capital. Note that where there have been multiple closings over more than one vintage year, the chart shows all the investment as having taken place in the original vintage year. So for example, if a £10 million evergreen fund was established in 1999 and subsequently topped up with an additional £5m in 2002, the chart would show this as £15m in 1999.



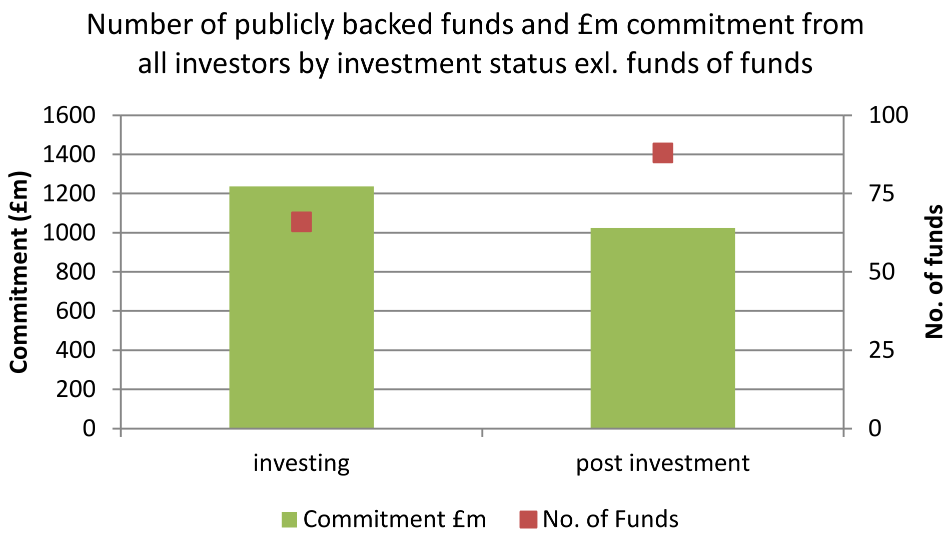
As the chart shows, there has been a huge increase in the amounts committed to publicly backed funds in recent years. From 2009 and 2011, a total of £1.4 billion was committed to 65 funds. This includes £550m committed to the four JEREMIE holding funds in Wales, Yorkshire and the Humber, the North West and the North East, the £75m Capital for Enterprise Fund, £50m committed to the Angel Co-Investment Fund from the Regional Growth Fund and £325m committed to the two UK Innovation Investment funds of funds (UKIIF).

5. Funds by investment status

Almost 70 funds encompassing around £1.6 billion in commitments are still in their investment period and able to make new investments (as opposed to only following on in their existing portfolios). This includes money committed to funds of funds that invest in funds that in turn invest in companies. The figure also includes some evergreen funds that although technically able to invest may well be fully invested and will need to realise some of their existing portfolio before making any new investments.



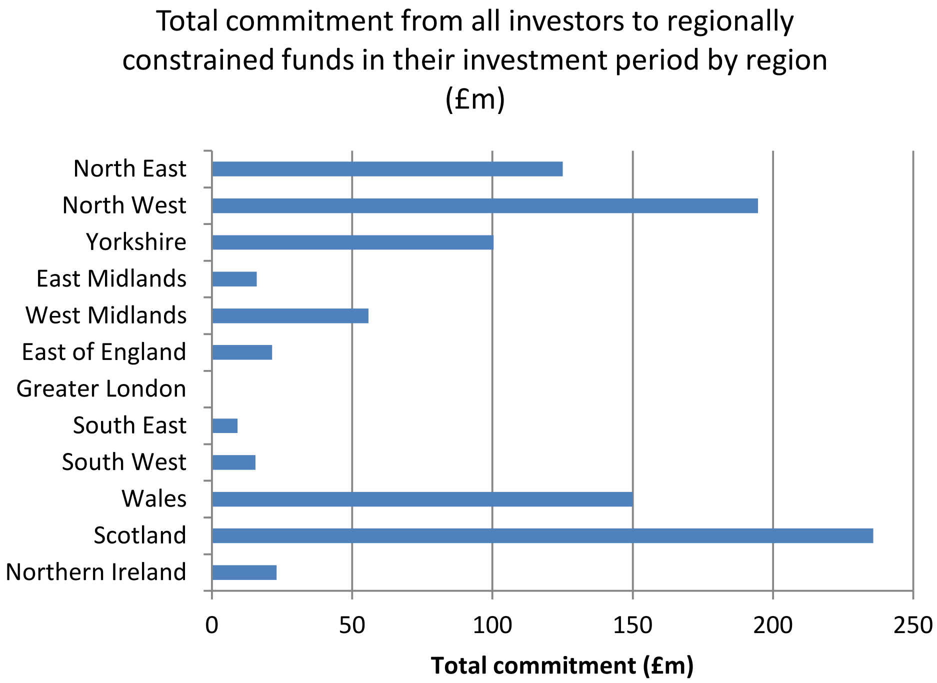
Taken out of context, it appears from the above chart that there has been a large increase in average size of funds as more money has been committed to fewer investing funds. While this is true, the data is skewed by the recent large UKIIF funds of funds. However, even excluding these funds of funds and the 2000 vintage UK High Technology fund of funds, the difference is still marked.



The average size of the investing funds excluding UKIIF is £18 million. This compares to £12 million for the funds in their post investment period. There has been a move towards larger fund sizes across the board. The average size of the first round of five Enterprise Capital Funds which all recently came to the end of their investment periods was £23m. The average size of the five ECFs in their investment period is £32m. Likewise, the average size of funds established by RDAs has also increased. The average size of those former RDA funds in their post investment period is £7m compared to an average of £13m for those currently investing. This figure takes into the account the English JEREMIE sub-funds (16 in total).

6. Funds by regional focus

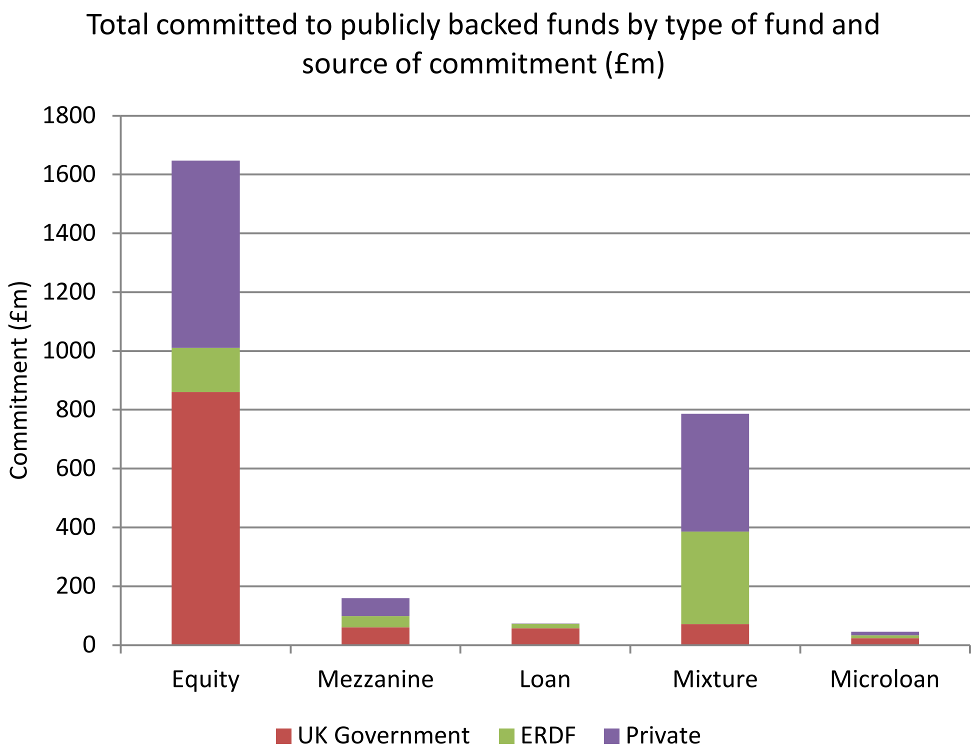
Of the £1.6 billion commitment to funds which are still investing, three fifths is committed to funds with a regionally constrained investment policy. Commitment by country and region of the UK is shown in the chart below.



The regional distribution reflects to some extent the allocation of ERDF money with the three northern regions of the UK along with Scotland and Wales receiving the largest amount of targeted investment. The Scottish Government, through Scottish Enterprise and the Scottish Investment Bank, has been a particularly active investor.

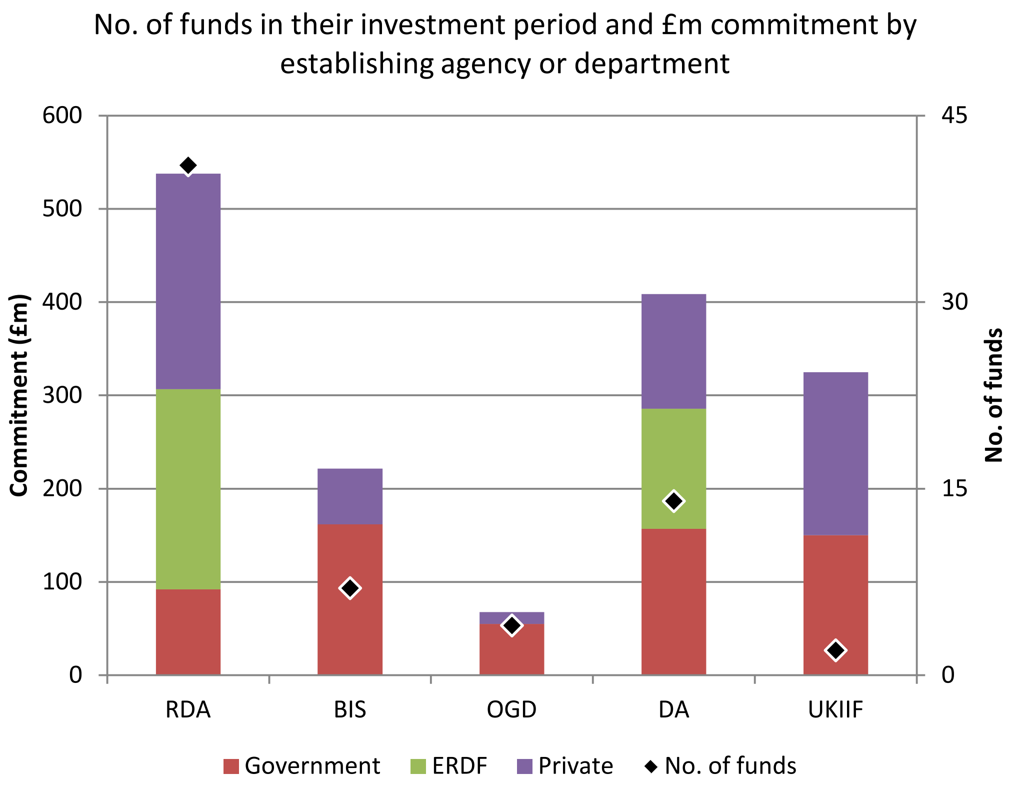
7. Types of fund – equity, mezzanine, loans and microloans

Publicly backed venture capital funds do not only invest in pure equity. Deals are often complexly structured and may combine debt, mezzanine and equity finance. They do however primarily invest in equity. That said a number of publicly backed funds have been established to make loan or mezzanine investments. The Regional Development Agencies in particular, sometimes actively encouraged by central Government, have established a number of loan funds. Furthermore, many funds have been specifically designed to offer mezzanine finance. Finally, government and more recently RDAs, have used money to support microloan funds often operated by Community Development Finance Institutions (CDFIs). The chart below shows the amounts committed by various sources to these different types of fund. It is not completely clear cut. A fund established to provide equity might in end up investing in mainly mezzanine and debt finance. The “mixed” category reflects cases where money has been invested into a holding fund such as a JEREMIE holding company and that holding company in turn invests in range of funds with different funds often providing different types of finance. As can be seen from the chart, the lion’s share of the ERDF investment has gone into this type of fund structure.



8. Funds by establishing agency or department

Funds have been established and invested in by different government departments, Regional Development Agencies and devolved administrations. The chart below shows the number of funds making new investments and the amounts committed to these funds from different sources by the department or agency establishing the fund. Although the UK Innovation Investment Fund (UKIIF) was established by the Department for Innovation Universities and Skills (now part of BIS), the funds are shown separately to illustrate the relative size of the programme compared to the other BIS funds.



It is clear from the chart that the Regional Development Agencies have been highly active in the establishment of VCLFs both in terms of the number of funds created and the amounts committed by all investors. In particular, RDAs have deployed more than £200m of ERDF for such purposes, and historically even more than this (the chart above only shows actively investing funds). The total amount committed to RDA funds is about the same as that committed to all active BIS funds including UKIIF.

The amount of private commitment to the RDA funds and the BIS funds including UKIIF is about the same, although the nature of that commitment is very different. Whereas the private commitment to the BIS funds and UKIIF is primarily via limited partnership structures and comes from a range of institutional investors, pension funds and private individuals, the vast majority of the private commitment to RDA funds is by way of loans from the European Investment Bank to the JEREMIE companies (£200 million).

The funds established by other government departments appear from the chart to be less effective than other funds at leveraging private investment. However, this is because the Carbon Trust co-investment funds, where private sector investment comes in at deal level, dominate this category. In order make fair comparisons as to how effective the various funds are at leveraging private investment, we would need information on a deal by deal basis for all funds. Even then, it is not always clear whether any private sector investment at deal level is additional.

From the chart it appears the average size of RDA funds is much smaller than that for other funds. £530 million commitment over 40 or so funds gives an average fund size of £13 million. However, this figure is distorted by a number of microloan funds averaging £2.5 million. Excluding these, the average size of the investing RDA funds (including JEREMIE sub-funds) is £16 million.

9. Conclusions and next steps

This report shows that £1.6 billion of UK government and European money has unlocked £1.1 billion in private commitments to public backed venture capital and loan funds over the past decade or so. The actual amount of private money leveraged is much greater as these figures do not include private investment at deal level. Although this may seem like a lot of money, this covers only part of the financial support for SMEs from Government. To put these figures in context, in less than two years (between January 2009 and September 2011) the Enterprise Finance Guarantee unlocked an additional £1.4 billion of bank lending to SMEs[3]. In the latest financial year for which figures are available (2009-10), the cost of research and development tax credits for SMEs was £320 million[4].

It is also clear from the report that there is great variety in the ways public money has been put to work through venture capital and loan funds; variety in the structures employed, the sizes of funds and the funding instruments used. This variety has resulted in a complex landscape where consistent information on the performance of funds can be hard to come by. In some ways, the report raises more questions than it answers. For example: *How much of the commitment to publicly backed funds has been invested? How are those investments performing? What has been the impact of this investment on employment?* These are the types of questions CfEL hopes to be able to answer through future reports. Currently information is fragmented and not all fund managers capture information on a consistent basis. CfEL is working with stakeholders towards a common assessment framework that will as far as possible enable fund operators, policy makers and the wider public to understand the performance of publicly backed funds on a consistent basis. This framework should cover both the financial performance (amount invested; number of companies invested in; amount and number of companies where investment has been written off; amount and number of companies where investment has been written up in value etc) as well as the wider economic outputs arising from the investment (jobs created and safeguarded; turnover growth etc). Finally, CfEL will seek to bring together the information on financial performance and wider economic benefits to better understand and quantify the relationship between them. CfEL has committed to producing an annual report on publicly-backed VCLF provision. The first of these reports will cover

[3] http://www.bis.gov.uk/policies/enterprise-and-business-support/access-to-finance/enterprise-finance-guarantee/efg-statistics

[4] http://www.hmrc.gov.uk/stats/corporate_tax/rd-accrualsbasis.pdf

more detail than is contained in this baseline report. The subsequent reports will be progressively more detailed and will ultimately cover the full breadth and depth of available information. CfEL's aim is that these reports become an essential tool to inform stakeholders and other interested parties as to the scale and success (or otherwise) of these types of financial intervention.

10. Further information

For Small and Medium-Sized Enterprises seeking finance, please visit the business link website: http://www.businesslink.gov.uk

For more information about the portfolio of funds under CfEL oversight (excluding those recently transferred from the Regional Development Agencies): http://www.capitalforenterprise.gov.uk/portfolio

For more information about the Business Angel Co-investment fund: http://www.angelcofund.co.uk/