THE EARLY STAGE RISK CAPITAL MARKET IN SCOTLAND:

evidence from three surveys

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1. INTRODUCTION

- Regional equity gap issue
  - Supply side - concentration of institutional VC in ‘south’:
    - SE/London/East of England attracted 53% of early stage investments and 72% of amount invested, 2001-3 (BVCA statistics)
  - Demand side – regional variations in distribution of ‘VC-eligible’ companies
  - Interaction – familiarity of firms and advisors with VC conventions (e.g. investor readiness)

Introduction II

- Policy response – stimulate the early stage VC market in the regions through creation of 'public sector' VC funds (various models)
- Data limitations – evidence is based on BVCA data on investment activity
    - Excludes non-BVCA members (mostly smaller, regionally focused funds)
    - Excludes most non-UK investors
    - Excludes corporate venturing
    - Excludes angel syndicates, business angels and other providers of informal risk capital

Introduction III

- Consequence –
  - incomplete picture which significantly underestimates available supply of early stage risk capital
  - Possible misspecification of case for *and* forms of intervention to address the ‘regional equity gap’

2. THE PAPER – THE CASE OF SCOTLAND

- Comparison of evidence on the risk capital market data for Scotland from three surveys
  - BVCA – the ‘official’ data
  - Equitas data – the UEMS study
  - GEM
- Each survey offers different view of risk capital market in Scotland
- Consequence: confusing message for policy makers

3. BVCA SURVEY

- Just over £1bn invested in 426 deals, 2000-2003 (four years)
- Steady fall in number of deals, from 125 in 2000 to 86 in 2003.
- More pronounced fall in amounts invested, from £440m in 2001 to £109m in 2003 (lowest total since 1994)
- Scotland’s share of UK VC activity has fallen:
  - From 11% to 7% for deals (2000-3)
  - From 9% to 3% for amount invested
  - Scotland’s location quotient for deals has fallen below 1.0 in 2002 and 2003
  - Scotland’s location quotient for the amount invested has remained at around 0.8

BVCA Survey II

- Funding by stage, 2000 – 2003 inclusive:
  - Early stage: 142 financings with a total value of £119m (mean = £0.84m)
  - Expansion: 242 financings with a total value of £545m (mean = £2.25m)
  - MBO/MBI: 42 financings with a total value of £418m (mean = £9.95m)
- Sharp fall in investment activity in 2003 – decline most pronounced in early stage category: just 22 early stage investments with a value of £7m in 2003

4. EQUITAS DATA (Harrison and Don, 2004)

- BVCA data are based on reporting by the providers of VC: i.e. the supply side
- Equitas data are based on the identification of recipients of VC:
  - Variety of sources of information on deals: e.g. press, informants involved in deal-making activity
  - Companies House (CH) files on such companies are consulted for information on the investments – all incorporated companies in Scotland are legally obliged to file details of investments received with CH (form 882)
  - Company accounts may also be checked

Equitas data II

- Coverage of Equitas data:
  - Includes all young companies operating primarily or exclusively in Scotland that have received risk equity from unconnected third party sources: replacement capital is excluded; stock exchange investments are excluded (Ofex, AIM, LSE)
  - Includes investments whatever the location of the investor
  - Excludes investments connected by blood or marriage
  - Includes deals in which the finance has been provided in the form of loans, loan stock, loan equipment, guarantees and other risk bearing debt instruments
  - Includes only the amount of funding drawn down, not 'headline' investment totals

Equitas III

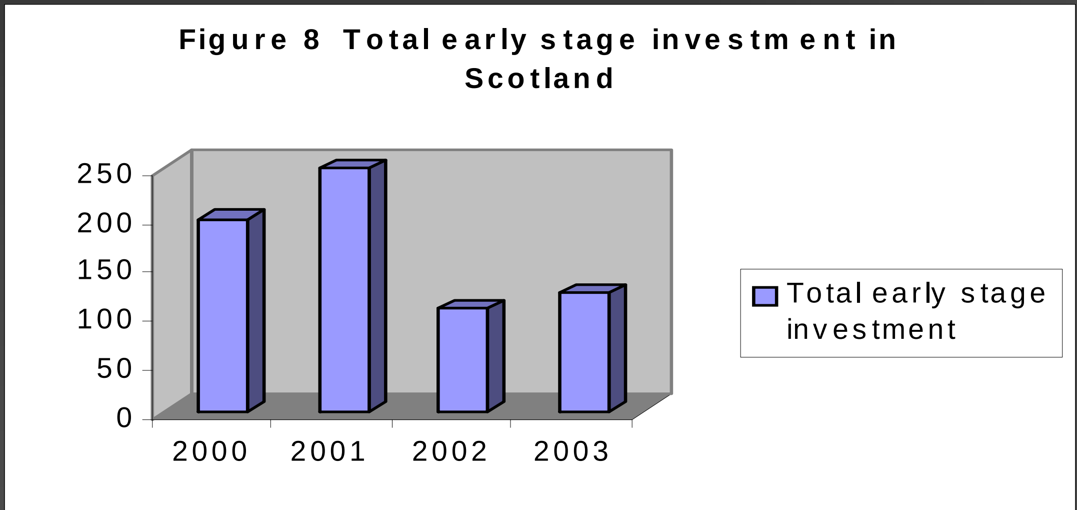
- Limitations of Equitas data
  - Reporting obligation only relates to shares, so debt instruments may not be included
  - Delays in filing of information with CH
  - Filings may not be done properly
  - Company accounts may be filed up to 22 months after any transaction
  - Tracking is complicated by use of trade names, change of names, complex ownership structures
  - Multiple parties involved in a deal may result in double counting
  - May not be possible to distinguish between founders and business angels
  - Use of offshore vehicles by investors to manage tax liabilities
  - CH does not publish a list of 882 listings, so extremely difficult to identify a company raising money if no ‘footprint’ is available

Equitas IV

- Players in the market
  - Business angels – private individuals investing their own capital on their own account as principals. Include angels who invest through syndicates and family trusts
  - Institutions – conventional VC firms, limited partnerships, corporate investors, offshore investment funds, collective investment companies, banks and investment trusts [The great majority, but not all, of the members of the BVCA will be included under this category]
  - Hybrids – investors which have an objective that combines financial returns with economic development: e.g. Scottish Enterprise (Co-Investment Fund, Business Growth Fund), local authority funds, PSYBT, University Challenge Funds
  - Founders – investments made by the founding principals of the investee company

Equitas V

- £673m invested in 581 early stage transactions 2000 – 2003.



Equitas VI

- Behind this picture are two separate trends:
  - The market for mega investments in pharmaceuticals and opto-electronics
  - The market for less capital-intensive young companies
  - Presence of a few large deals creates volatility in the market

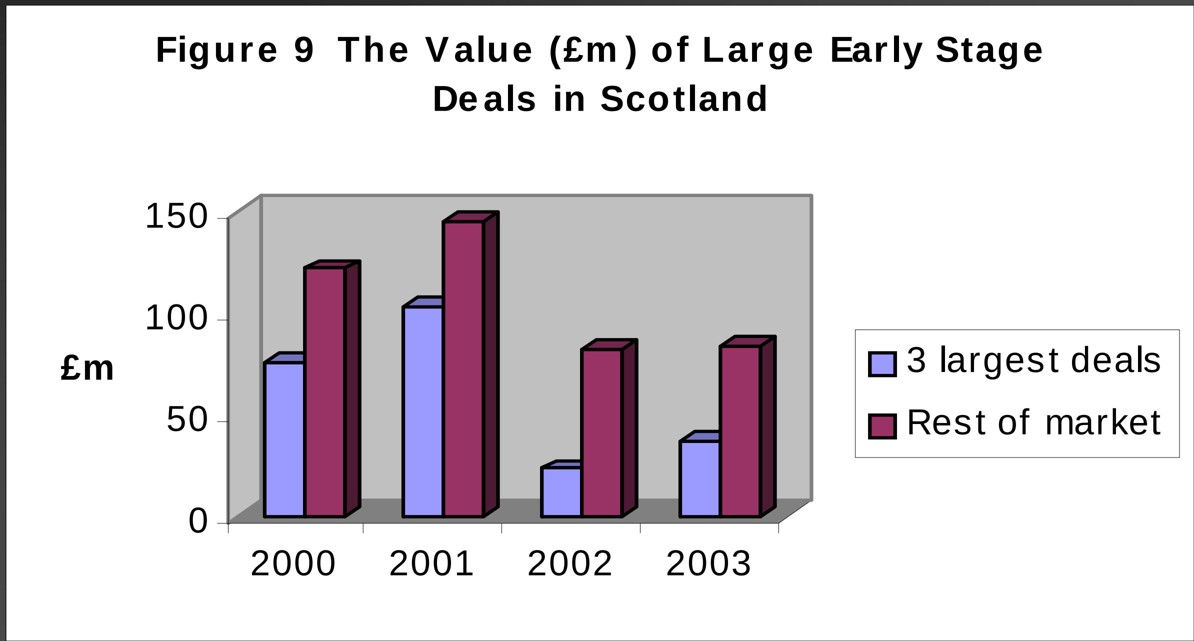


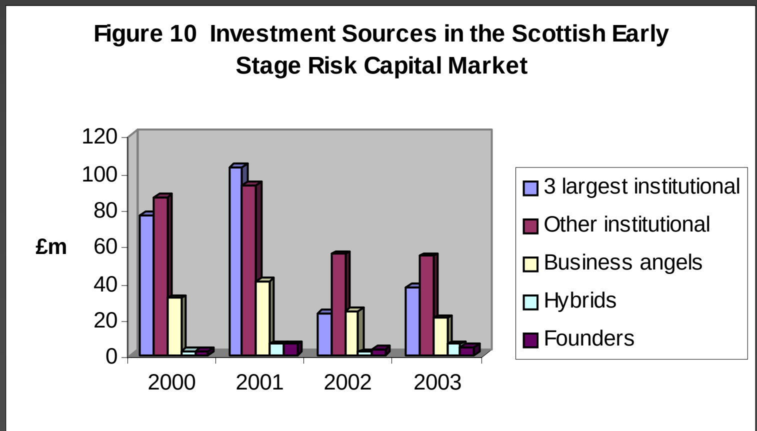
Figure 9 The Value (£m) of Large Early Stage Deals in Scotland
150
100
50
0
£m
2000
2001
2002
2003
3 largest deals
Rest of market

Equitas VII

- Equitas data suggests that there is much more activity in the early stage equity market in Scotland than is undertaken and reported by BVCA members:
  - Total reported early stage investment by BVCA members, 2000 to 2003 inclusive, is £119m
  - Total early stage investment identified by Equitas over the same period is £673m
  - BVCA member early stage investment fell from £100m in 2000-2001 to £19m in 2002-2003 (-81%)
  - Equitas statistics indicate a fall from £447m to £226m over this period (-49%)

Equitas VIII

- Players in the market:
  - Institutional investors dominate the market
  - Business angels account for 27% of total early stage investment



Equitas IX

- Hybrids account for £15.5m out of £673m, 2000 to 2003 but becoming increasingly significant in terms of number of investments: 44% in 2003.
- Hybrids becoming increasingly important in funding smaller deals – e.g. SCF is a catalyst in the market co-investing alongside other investors

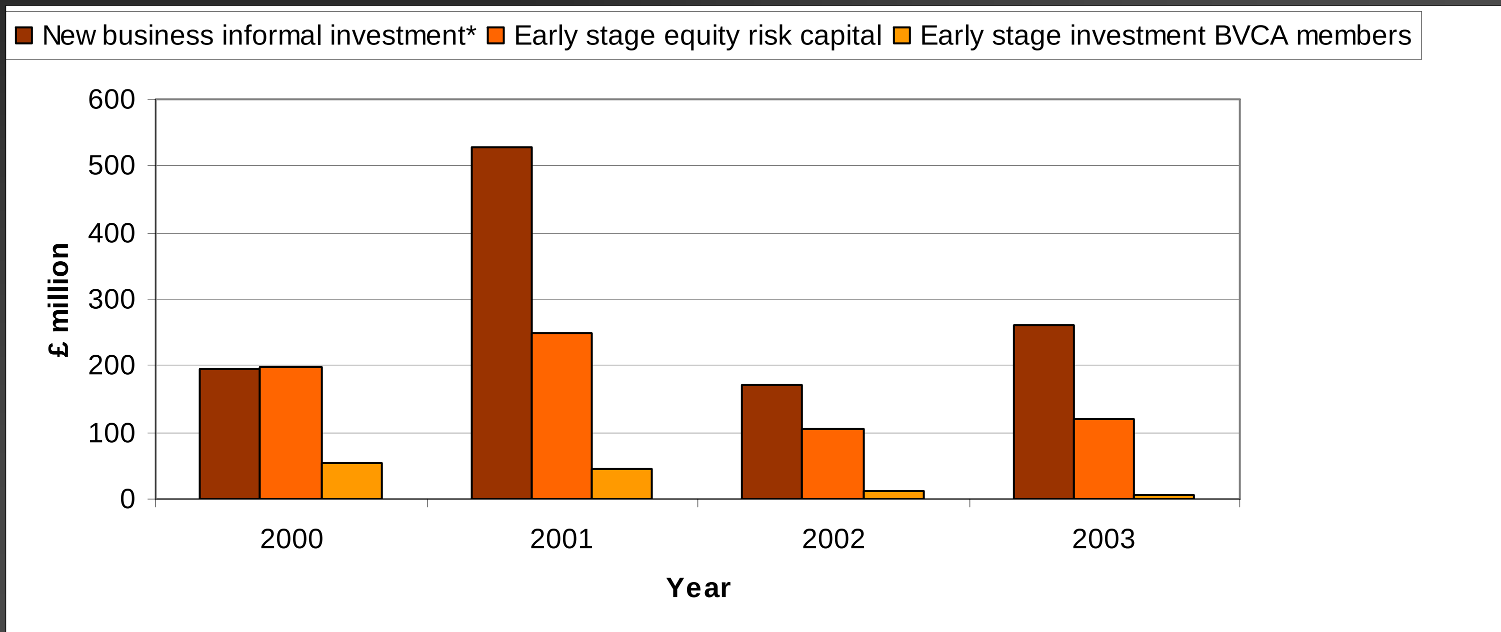
5. GEM SURVEY (Levie, Carter and Currie, 2004)

- Annual survey of 2000 individuals to identify the level of entrepreneurial activity
- International programme: 34 countries in 2004.
- Asks: “have you, in the past three years, personally provided funds for a new business started by someone else, excluding the purchase of any stocks or mutual funds?”
- Is therefore measuring “informal investment”
  - Investment in family-owned businesses – ‘blood money’
  - Investment in businesses started by friends
  - ‘pure’ angel investments

GEM II

- Average annual amount invested by individuals in new businesses owned by others for the period 1999 to 2003 is £390m (or £178m if the largest 5% of reported investments is excluded)
- GEM Scotland’s estimate of informal investment exceeds both Equitas and BVCA figures
- Scotland’s rate of informal investment is well below that of comparator nations (1.3% of population, cf. 3.0% in small modern nations)

GEM III


New business informal investment*
Early stage equity risk capital
Early stage investment BVCA members
600
500
400
300
200
100
0
£ million
2000
2001
2002
2003
Year

GEM IV

- 78% of informal investors invested in businesses of family members in 2003 (average of 76% over 5 years – cf. 50% in UK GEM)
- Only 4.3% of investments 1999-2003 were business angel type investments (investments in businesses owned by strangers

6. IMPLICATIONS

- There is more early stage risk capital available in the regions than ‘official’ data suggests
  - From the household economy
  - From angel investors
  - From institutional investors
- BVCA represents only part of the market
  - Underestimates total market – informal sources outweigh formal sources
  - Poor guide to development of policy intervention, in absence of other detailed market knowledge

Implications II

- Each region may be different
  - Scotland has more active angel syndicates
  - English regions may differ from each other
  - Need for intervention, and appropriate form of intervention (e.g. co-investment funds), may vary by region
  - Policy in Scotland [Business Growth Fund, Scottish Co-investment Fund] appears to be successful because designed in close association with key market actors

Implications III

- We have demonstrated that the early stage risk capital market is larger than previously estimated – but cannot conclude from this that supply is adequate or is transparent:
  - Lack of access to capital may: (i) discourage people who have ideas and identify opportunities from developing them; (ii) discourage or prevent expansion by existing businesses; (iii) contribute to the closure of existing businesses – but difficult to establish an audit trail

Implications IV

- Scotland's entrepreneurial activity rate lags that of many other developed countries. If its entrepreneurial activity rate was to rise to that of more dynamic regions and countries there would be a total requirement from all sources of £135bn risk capital investment per annum.
- However, it is estimated that a funding gap of £260m would remain after making full allowance for the potential increased contributions from private investors, institutional capital and unsecured debt (e.g. SFLGS)
- Key problem is the insufficient personal wealth in Scotland (a function of the limited number and modest size of exits in the past) – lack of 'super angels'
- Need for new private sector evergreen funds (with material public sector support) which generate their return through dividends rather than exit