A Mapping Study of Venture Capital Provision to SMEs in England

Research

October 2005

dti
A DTI SERVICE

Contents

Executive summary ... 1
Methodology and Definitions ... 4
- Definitions ... 5
- Regional breakdown ... 6
- Types of funds ... 6

Background to venture provision ... 9
- A short history of public sector involvement in the provision of venture finance ... 9
- Changing tastes in the venture sector ... 10
- Recent fundraising ... 11
- Outlook for fundraising ... 11
- The main difference between publicly and privately-backed funds ... 12
- Regional issues ... 13

The Population of Investors ... 14
- The shifting population of funds ... 14
- Identifying the active universe of investors ... 15
- Breakdown of active funds ... 16
- The size of funds ... 17
- The age of funds ... 17
- Regional analysis ... 19
- Summary ... 21

Specialists and generalists ... 23
- Breakdown of funds by specialisation ... 24
- Specialisation by fund type ... 24
- Location of specialists ... 26
- Stage predominance of specialists ... 27
- Summary ... 28

Fund Sizes and Sources of Capital ... 29
- Fund Sizes ... 29
- Sources of capital ... 34
- The UK public sector as an investor ... 34
- Summary ... 37

Analysis of teams ... 39
- Team size ... 39
- Team size and investment activity ... 42
- Summary ... 42

Investment Activity ... 43

Number of investments 43
Size of Investments 49
Co-investment 51
Public and private overlap 54
Summary 54
Regional Investment Activity 55
Investments by region 55
Investment size by region 60
Value of investment in each region 61
Regional investment activity by stage 62
Regional investment activity by sector 62
Summary 66
Appendix 1 67
The relationship between different fund types 67
Specific obstacles to investment 68
Equity Gaps 69
Supply of public capital 70
Issues affecting the publicly-backed funds 70
Perception of the publicly-backed funds 72
Appendix 2 – Regional Analysis 74
North East 74
Yorkshire and Humberside 76
East Midlands 78
Eastern region 80
London 82
South East 84
South West 86
West Midlands 88
North West and Merseyside 90

Executive summary

The supply of venture capital to SMEs in England varies dramatically from one region to the other. This study, however, shows that the distribution of capital around the country would be considerably more uneven were it not for the activities of publicly-backed funds. Most are almost unique within the venture population in having an explicit regional focus, thereby going some way to address regional equity gaps. They are also significantly more likely to make smaller investments, sub-£500,000, than the other providers of capital, thus addressing an investment stage gap. Indeed, the evidence suggests their establishment has been almost entirely complementary to the existing universe, rather than creating distortions in the market.

Aims and objectives

The aim of the study is to map out the provision of venture capital to small and medium-sized enterprises in England with the main purpose of producing an evidence base for policy-makers. This means identifying all the active equity funds and formal angel networks operating in this segment, both privately backed and publicly backed, and reporting on the nature of the funds, the size and source of their funds, and the scale of their investment activity. Finally, the study explores the way in which publicly-backed funds are working with privately-backed funds and others in the market to stimulate sustainable sources of finance for SMEs.

Key findings

- The population of venture providers is constantly shifting, both in size and shape. At present, there are some 191 funds being managed by 131 different firms.

- The public sector has become an important force in the venture sector. Some 50, or 26 per cent, of all the active funds are publicly-backed; 32 per cent of these wholly and 68 per cent partly. Indeed, in the last three years, the public sector has accounted for more than half of all the new active funds. Privately-backed funds, in contrast, have suffered an extremely unsympathetic fundraising environment since 2001.

- The regional distribution of funds is heavily weighted in favour of London, which is home to roughly half of all active funds. This appears to be mainly a function of its importance as a source of capital rather than as a source of deal flow and there are funds with a specific regional focus spread more evenly around the country. Again, the public sector has been the main driver in the creation of regionally-focused funds, accounting for 62 per cent of

them. Privately-backed funds, with the exception of angel networks, are almost always pan-regional.

- The population of active funds is split almost half and half between specialists and generalists.

- Specialist funds, most of which are VCs rather than any other fund type, tend to be concentrated around the source of capital rather than the supply of deal flow on the basis that the best technology transcends geography. Almost 60 per cent of all specialist funds are based in London. But there are also a significant number of specialists based around the major technology clusters in the South East and Eastern regions.

- Historically, specialists have had a focus on early stage investing but recent years have seen a shift towards the later stages as a means of mitigating risk. The study found that during 2003 and 2004 more than a third of specialists had been investing predominantly at the growth capital stage, meaning the companies were likely to be cash flow positive rather than early stage or start-up. This pattern is less pronounced among publicly-backed specialists, mainly the University Challenge Seed Funds (UCSFs), which are limited in the size of investment they can make and thus have less flexibility to adjust their strategy to the financial cycle.

- The largest funds are managed by venture capital firms (VCs), averaging £60m, and are typically more than three times the size of other fund types. Venture Capital Trusts (VCTs) are on average around £23m, while the average publicly-backed fund is £13m.

- VCs are predominantly investing in technology sectors, which are highly capital intensive and require large amounts of money to build profitable businesses.

- The much bigger size of VC funds is also a function of the sources of their capital. Their money is typically raised from institutional investors – pension funds, insurance companies, asset managers and funds of funds. These institutions have minimum investment limits, which preclude them investing in small funds. There has been some investment by local authority pension funds in regional venture capital funds (RVCFs), which tend to be smaller than conventional VC funds, but the quantities are not large by comparison with the VCs.

- The publicly-backed funds accounted for 558, or nearly a third, of the 1714 qualifying investments made during 2003 and 2004, making them an extremely important source of capital to the SME sector.

- Despite the significance of the publicly-backed funds, there appears to be little in the way of a disruptive overlap between their activities and those of the privately-backed funds. The RVCFs are judged to play a complementary rather than competitive role in the provision of venture finance, while the UCSFs are among only a very small pool of dedicated seed investors faced with substantial demand.

About this project

This research was commissioned by the government's Small Business Investment Taskforce and was done in partnership with the CBI. It also contributes to the Small Business Service's evidence base to support the Government Action Plan for Small Business. The data were gathered by means of a survey and telephone interviews carried out between December 2004 and March 2005. Respondents provided information on the basis that it would only be used in aggregated form.

1

Methodology and Definitions

1.1 The aim of the study is to map out the provision of venture capital to small and medium-sized enterprises in England with the main purpose of producing an evidence base for policy-makers. This means identifying all the active equity funds and formal angel networks operating in this segment, both privately backed and publicly backed, and reporting on the nature of the funds, the size and source of their funds, and the scale of their investment activity. Finally, the study explores the way in which publicly-backed funds are working with privately-backed funds and others in the market to stimulate sustainable sources of finance for SMEs.

Methodology

1.2 The study was built on a comprehensive survey of the universe of active providers of venture finance to small and medium-sized enterprises in England. The initial stage of the project was focused on identifying these providers, using Almeida Capital's proprietary data sources as well as public sources such as the membership list of the British Venture Capital Association. The list of providers was supplemented throughout the study period as respondents referred to firms or networks that had not been previously identified.

1.3 The second stage of the project was to make contact by telephone with all the targets and inform them that they would be provided with a questionnaire. Some respondents preferred to provide the data over the telephone rather than complete the document itself. Many others were interviewed subsequent to completing the questionnaire to ensure the accuracy of their submissions and to develop issues that arose from their particular activities. As a result, Almeida interviewed considerably more than half of the universe of active managers.

1.4 The interviews and questionnaires were conducted and completed between December 2004 and March 2005. All information was provided on the guarantee of confidentiality and on the basis that it would only be used in aggregated form. Some 15 per cent of the active universe declined to provide data for the survey but the actuality of their activity was verified from other sources and in some instances it was possible to produce an accurate estimate of their levels of investment.

Definitions

Venture Capital

1.5 The most fundamental definitional sensitivity in the study relates to the term **'venture capital'**. The term, at least as it has been employed in the UK, has historically encapsulated the full spectrum of private equity activity; the provision of equity finance to private businesses in return for a minority or a majority stake. Some newspaper reports, for example, will still refer to the very largest private equity groups, such as Permira or the US firm Kohlberg Kravis & Roberts, as being venture capitalists. There has been, however, a gradual convergence within the industry towards the US definition, where 'venture capital' is limited to describing investment provided in the earlier stages of a company's life and particularly in technology-oriented sectors. This study was concerned with all forms of private equity provision to SMEs, regardless of stage or sector, but excluding all buy-out investment. For the purposes of the report, this can be considered to be predominantly venture-related.

Active investors

1.6 Venture providers frequently move out of the market, either because they fail to raise further funds for investment or because they change their investment strategy. In order to provide an accurate picture of dependable suppliers of venture finance to SMEs, it was important to limit the scope of the project to those that were consistently **active** during the study period 2003 and 2004. For the purposes of the study, this meant firms that made qualifying investments during that period or that were able to demonstrate they still had capital but had simply not been able to find attractive opportunities. A significant number of initial targets were excluded as inactive after being contacted because they had not been active during the period.

Stages of investment

1.7 The **stages of investment** used throughout the report are consistent with the definitions used by the British Venture Capital Association (BVCA) and essentially refer to the maturity of the investee business. They are as follows: **Seed**; to allow a business concept to be developed, perhaps involving the production of a business plan, prototypes and additional research, prior to bringing a product to market. **Start-up**; to develop the company's products and fund their initial marketing. **Growth**; to grow and expand an established company.

Investment

1.8 The term investment refers both to new and follow-on investments throughout the report. This means that the number of investments referred to at any point does not equate the number of companies receiving venture finance for the first time. Similarly, the high incidence of **co-investment**, whereby two or more venture providers join forces to invest alongside one another, also means that the number of investments cannot be equated to the number of firms being backed.

Stage Predominance

1.9 This refers to the emphasis, defined as the majority of their investments during the study period, of respondents' investment activity. If, for example, more than half of all the investments they have made were at seed stage then they have been categorised as a seed-predominant investor. The purpose of this approach was to circumvent the fact that many groups describe themselves as having a particular stage focus but in reality have, at least over the study period, been investing more heavily at a different stage. Where a fund has no clear stage predominance then it has been categorised as such.

1.10 The stage focus of the study ranges from seed investing to growth and development capital but some of the funds also make buy-out investments. These buy-out investments, however, have been excluded from the study.

Regional breakdown

1.11 The regional breakdown uses the government office regions.

Types of funds

1.12 The study broke the providers down into five main categories: publicly-backed funds, venture capital firms, venture capital trusts, angel networks and other funds. Individuals have only been included where they invest through a formalised angel network. This means that a significant constituency, the large individual investor, has been excluded from the study, mainly because they cannot be considered to be truly systematic. They are generally active at the smaller end of the spectrum, making seed or start-up investments of considerably less than £500,000.

Publicly-backed funds

1.13 Publicly-backed funds are those that have received capital from the public sector, ranging from central government departments to regional development agencies or European Union funds. They include the Regional Venture Capital Funds (RVCFs), the Early Growth Funds (EGFs), the University Challenge Seed Funds (UCSFs), and funds backed by the European Regional Development Fund. There are also a handful of other publicly-backed initiatives with a particular sector focus, such as the Recycling Fund. Although the public sector is not always the majority investor in these funds, as is the case with the RVCFs, it is the cornerstone investor and in every occasion the primary agent in the establishment of the fund. Despite the importance of the public sector in backing these funds, they are all managed by independent teams.

1.14 The study further breaks down publicly-backed funds into those that are wholly and those that are partly funded by public sector bodies. (Funds that have raised capital from the European Investment Fund (EIF) are not treated as being publicly-backed.) There are a series of limitations on the way publicly-backed funds can invest. The RVCFs, for example, are limited to investing £250,000 at a time and may not invest more than £500,000 in a single company. They are also required to be the first source of institutional capital, which means

they are generally able only to co-invest with angel networks rather than other venture capital providers. The EGFs are limited to a maximum initial investment of £100,000 and are usually required to source match funding, or equivalent co-investment, from a private sector investor. UCSFs have the same limit on initial investment size as the EGFs and a maximum of £250,000 per firm. All their investments must also be in firms emerging from their target universities.

1.15 All the publicly-backed funds are managed by independent, private sector managers and not by public sector bodies. Some of these managers are responsible for a number of funds, some publicly backed and some entirely privately backed. Other publicly-backed funds are managed by a dedicated team. There are limitations and restrictions in every instance relating to how or where they invest in order to ensure that the target equity gap is most efficiently addressed. But even where the funds are investing according to the same remit, such as the RVCFs, there are a wide variety of strategies in evidence.

Venture capital firms

1.16 Venture capital firms are independent organisations whose primary activity is investing in private businesses. Their capital supply is generally structured as a limited partnership with a ten-year life and is composed of a number of private sector institutions and occasionally high net worth individuals. VCs are typically investing out of just one fund even if they are continuing to manage predecessor funds to steer portfolio companies towards an exit. In other words, they do not reinvest profits and manage their funds concurrently rather than in parallel. They may invest across the range of stages, from seed to buy-out, but this study was only concerned with their non buy-out activity.

Venture capital trusts

1.17 Venture capital trusts (VCTs) are listed funds that invest according to a set of criteria to qualify for privileged tax treatment. The source of their capital is typically high net worth individuals or retail investors. The rules attached to VCT qualification require a large proportion of the fund to be invested within a given period of time. This means that they often have a few years of high levels of activity and then a much slower stretch while the investments are harvested. This phenomenon is particularly significant because there have been periods when fundraising has been much more active than others, generally a function of the financial cycle or, as is presently the case, following a change to their tax treatment. This, in turn, is reflected in the aggregate levels of VCT investment activity in the three years that follow fundraising. In other words, the investment of VCTs is lumpy over time as a consequence of the financial and fundraising cycle. They are, however, effectively evergreen as a source of capital, reinvesting profits rather than liquidating the fund after a defined time period as with VC funds.

1.18 Many of them now concentrate their investment activity on AIM-listed companies or buy-out opportunities, often pooling their resources to finance much larger deals than would be achievable or allowable from a single fund. Once again, these investments have

been excluded. A number of VCT managers have more than one fund under management, often with similar investment strategies. These are sometimes managed by the same team and often invest alongside one another.

Angel networks

1.19 Angel networks are essentially groups of individuals benefiting from the deal sourcing and deal screening capabilities of a central body. The network also enables them to pool their capital into larger chunks. This means they can participate on a much greater scale than would be the case if they were investing alone and spread the associated risks by diversifying across a number of opportunities. Like VCTs, there is often a cyclicality about angel investing driven by wider financial conditions. They do not invest out of dedicated pools of capital or funds but finance their investments on a deal by deal basis. This study, however, treats them as if they were a fund because they represent a dependable supply of capital in the same way as conventional funds. For the purposes of this study, the size of angel networks has been estimated by multiplying their annual investment capacity by five, being the average investment period for conventional funds.

1.20 Networks are usually organised geographically and several of them are backed by regional development agencies. There are also a number of privately-managed networks, sometimes with a particular regional focus and sometimes with a sector focus. There are, for example, a number of groups around the universities of Oxford and Cambridge, composed of business people and academics eager to exploit their existing professional relationships. There are considerable differences in the approach adopted by different networks, chiefly relating to the degree to which they become involved with their investee companies. Some act effectively just as a syndicate of investors providing capital while others become much more involved in the companies they back.

Other funds

1.21 'Other funds' include companies that invest off their balance sheet, listed investment companies and investment trusts, and corporate venturing units that do not have a supply of capital ring-fenced by their parent or provided in part by third party investors. The most significant firm in this category is 3i, one of the largest private equity investors in Europe. The study, however, has only included the activity of these firms that ranges from seed to growth capital and does not include buy-out investing.

2

Background to venture provision

2.1 The supply of venture capital to SMEs is now considered an integral part of a healthily functioning economy, enabling the formation and growth of businesses that are unable to raise debt or other sources of finance. It has, however, long been recognised that some parts of the economy, defined by stage, size and region, have suffered from gaps in the availability of equity finance. The last decade overall has seen dramatic growth in the levels of venture capital and private equity activity in the UK and elsewhere in continental Europe, notwithstanding the peak and trough of the 'dotcom' boom. It remains the case, however, that there are still sectors, stages and regions of the economy that do not have access to an adequate supply of venture finance.

A short history of public sector involvement in the provision of venture finance

2.2 The concept of an equity gap dates back to at least the 1931 Macmillan report to the Parliamentary Committee on Finance and Industry. The first major policy response came in 1945 with the establishment of the Industrial and Commercial Finance Corporation (ICFC), the forerunner of today's 3i. The model was adjusted and embellished in the decades that followed but the next major boost to the private equity industry came with the relaxation of credit controls and liberalisation of public securities markets in the 1970s and 1980s. The combined effect of these, and a host of other measures, was to make it easier and more attractive for private sector organisations to invest in unlisted businesses. The private equity or venture capital units of financial institutions were the largest part of the active population at this point but the longest established independent venture capital firms (VCs) date their origins to this point in time.

2.3 Whilst these measures all resulted in a serious sophistication in the availability of different sources of finance to SMEs, there remained gaps at different stages and in different sectors and different regions of the economy. The government attempted to address the aggregate supply-side problem by using fiscal incentives to draw more capital into the venture sector with the creation of venture capital trusts (VCTs) in the mid-1990s. Shortages of capital appeared, momentarily, to be a thing of the past during the latter stages of the 1990s. An upsurge of investor interest in technology investing, both from the retail and the institutional sector, helped fuel the creation of a wave of new private equity and venture capital firms (VCs).

However, the bursting of the technology bubble in 2000 and the resulting collapse in appetite for venture capital investing threw these positive developments into reverse.

2.4 The government has also responded to shortages of capital with a string of initiatives to address issues in specific parts of the market, both defined by stage and sector, and more broadly by region. The basic model has been to provide capital to be managed by independent fund managers, either supplemented by private sector investment in the fund or conditional on investments being matched by private sector capital. The first initiative was the launch of the university challenge seed funds (UCSFs), funded by the Office of Science and Technology in partnership with charitable endowments and the recipient universities themselves. This was followed by the launch of nine regional venture capital funds (RVCFs) by the Small Business Service, designed to make start-up and growth investments in SMEs. More recently, the government has rolled out a series of Early Growth Funds, targeting smaller investments, generally in technology-oriented investments. Other government departments have also financed vehicles, such as the Carbon Trust backed by the Department for Environment, Food and Rural Affairs.

Changing tastes in the venture sector

2.5 No period of time can truly be considered as 'typical'. The venture sector cannot be extricated from broader financial conditions and it is critical to appreciate the investment environment as being dynamic. The late 1990s, as described above, saw an unprecedented amount of early stage investment activity. The result was an explosion in the population of most types of funds, especially venture capital firms (VCs), VCTs and Angel networks. The subsequent implosion, however, brought the formation of new investment vehicles to an abrupt halt and the attempts of existing managers to raise new funds in the period that followed were often unsuccessful. The ensuing years saw and continue to see a significant contraction in the number of venture providers.

2.6 This development also had a significant impact on the way managers sought to invest their remaining capital, essentially reflecting a loss of appetite for risk at every stage of investment. There was a shift away from early stage investing and a move towards larger and more established businesses. Equally, a lot of VCTs that originally marketed themselves as early stage investors have now increased their buy-out investing and raised the target size of their deals. Even true venture capital firms that maintain a focus on information technology and life sciences have shifted their focus onto larger deals and away from the early stages. This is not always evident in their average investment sizes, which may be little changed over the last few years. But this masks the extent to which they are doing more syndicated deals – investing the same amount but alongside other investors in much larger and often more mature businesses.

2.7 Running in the background at the same time has been a broader trend among private equity groups during the course of the past decade towards more buy-out investing and away from growth and expansion financing. The drivers of this trend include the desire for

full control of investments as a means of mitigating risk and the attraction of cheaper leverage. It is often more difficult to get significant quantities of debt into growth financings, thus denying investors the benefit to returns of low interest rates. The result has been a more sharply defined bifurcation between venture and buy-out investing, sometimes leaving specialist growth capital investing unaddressed in the middle. While a number of buy-out firms continue to list growth and development capital investment among their activities, the reality in recent years has been that their focus has been almost exclusively on buy-outs.

Recent fundraising

2.8 For the reasons described above, the last few years have been extremely difficult for fundraisers, with the value of private equity fundraising as a whole in Europe falling 63 per cent from 48bn in 2000 to just 18bn in 2003. Venture capital fundraising suffered an even more precipitous drop, falling from more than 20bn in 2000 to just over 1bn in 2003. There were clear signs of a recovery in 2004 and into the first quarter of 2005. The value of final closes in 2004 was 25.4bn and the first quarter of 2005 recorded 8.6bn of closes, compared with 6.5bn in the same period of 2004. There has, however, been a heavy emphasis on buy-out rather venture capital funds, with the former accounting for 84 per cent of the total. The enduring diffidence about venture investing among the major institutions will ensure a strong gravitational pull towards later stage investing for the foreseeable future.

Outlook for fundraising

2.9 In this survey, VCs expect the fundraising outlook to remain difficult for all but the most experienced groups, which will continue to affect the availability of capital to the broader SME sector. "There is going to be further fall out as funds go through their next fundraising over the course of the coming year or two. It could have unfortunate consequences. The premier division will be alright but it is not very large," said one VC. Other VCs echoed the sentiment and in some instances were even more downbeat. "I wouldn't say the industry has shaken out. It's only going to be over the next couple of years that we find out how far that is going to go. It is possible that another 25 per cent of firms will fail to raise any more money and quite a lot have already folded in the knowledge they wouldn't raise any more," said another.

The main difference between publicly and privately-backed funds

2.10 There are a number of major differences between the publicly and the privately-backed funds, ranging from the volume of their investment activity and their regional and stage focus to the size of their teams and funds. But most of these stem from an even more fundamental difference that relates to the purity of their financial ambitions. Most simply, the privately-backed VCs have no motive besides trying to generate the maximum possible returns on their investments. They are entirely accountable to their investors for this performance and their survival or growth depends upon it. After all, it is this performance that will determine their ability to raise subsequent funds, prolong their existence, and enrich their managers. The motive of the publicly-backed funds is generally more complicated, as is to be expected of vehicles that have been conceived and established as tools of economic policy.

2.11 While all of the publicly-backed funds have a similar financial imperative to the privately-backed funds – namely that they should be attempting to generate commercial returns – they also have an explicit or implicit non-financial motive that informs or even limits the way they behave. Some of the EU-backed funds, for example, are required to focus on economically-disadvantaged areas of the country, which amounts to an explicit social motive. They are more interested in building a supportive environment for small business formation than they are in generating returns for their investors. Others, such as the RVCFs have a more implicit social motive; they are intended to maximise profit at the same time as being required to invest within certain size parameters as part of the government's ambition to encourage more private sector capital to address an equity size gap.

2.12 The principal mechanism for these publicly-backed funds to attract the private sector to their market area is realised performance. They have to be able to show the institutional investors and other providers of venture finance that their market can be commercially attractive. "Our remit is to prove that there are opportunities for VCs in our sector. We do that by proving there are decent returns and by demonstrating our expertise and ability to lead deals. That's the mechanism. At the end of the line we have to be able to show you can make money in this sector or we won't be able to attract other VCs," said the manager of one publicly-backed fund.

2.13 It is too early to be able to reach a meaningful judgement about the effectiveness of this mechanism because neither the RVCFs nor the UCSFs have had a long enough period over which to build and nurture a portfolio. The challenge has been particularly steep in the years immediately following the downturn in technology markets in 2000 and a full cycle will be required to enable comparison with privately-backed funds. "In terms of generating returns, it (the UCSF initiative) has not been a failure but we have not yet got a sufficient track record to attract a lot more money," said the manager of one UCSF.

2.14 It is also worth noting that while the publicly-backed funds often emphasise their financial motives and ambitions, there is often a starkly different perception among the privately-backed funds about their activities. Some of them are well regarded as VCs but others

are looked upon as subsidised investors. Although this very rarely extends to complaints about market distortion, some VCs talked about profound cultural differences between themselves and the publicly-backed funds. Some bemoan the quality of their investment teams. And some decry them for failing to integrate themselves properly into the existing venture infrastructure. At the extreme, VCs explain the contrast saying: "People like us are involved in straight commercial funding of early stage businesses whereas they (publicly-backed funds) seem to think there is some sort of grander obligation to the economy to establish these businesses. We don't always seem to speak the same language. They don't seem to understand that our obligation is to generate returns for our investors. The bottom line is that we will do whatever makes us money."

2.15 Many of the differences in behaviour between the two broad categories of funds explored subsequently in this report are a consequence of these contrasting motives. "You trigger a very different type of investment strategy depending where you are on the spectrum of wanting to make money or foster entrepreneurship," said the manager of another publicly-backed fund.

Regional issues

2.16 There have historically been a number of private equity firms with an extensive regional presence, most conspicuously 3i and the range of private equity units managed by banks and asset managers. Their local networks supplied them with a steady supply of deals that were too small to attract the attention of large-scale intermediaries in London. But recent years have seen a significant retrenchment and in many cases abandonment of these networks. Sometimes they were judged to be too expensive, particularly when captive groups were spun out of their parents and did not have the subsidised resource to maintain regional offices. Sometimes, the firms increased their target deal sizes to such an extent that the target businesses were visible from London. And sometimes the networks simply fell victim to cost cutting. The result, whatever the analysis, is a concentration of active funds in London.

2.17 The relative maturity of the English private equity industry and the resulting growth in the intermediation of transactions has simply compounded this London-centrism. Investment banks, corporate finance boutiques, and accounting firms are all now active in managing the transaction process from the very largest multi-billion pound deals to relatively modestly sized acquisitions or investments. Only those firms focusing on the smaller deals are generally thought to require a local presence. This centripetal effect is also informed from the capital supply side of the equation, in particular the present reticence among institutional investors to expose themselves to geographical risk by backing venture capital groups with a narrowly-defined regional focus. This has resulted, in its starkest form, in the massive increase in the size of multi-regional funds across Europe, which provide investors with the maximum amount of portfolio diversification by size of investment, stage, country and sector.

3

The Population of Investors

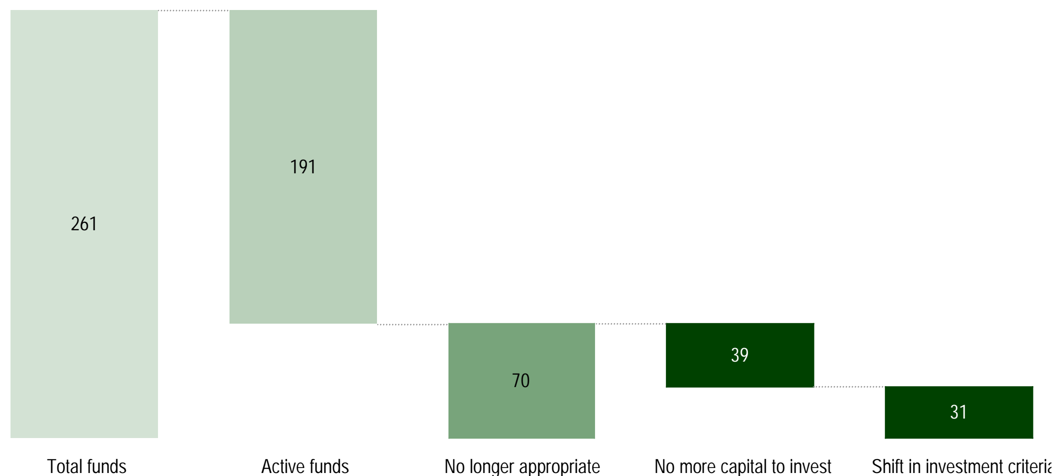
The shifting population of funds

3.1 The population of private equity investors in small and medium-sized enterprises (SMEs) in England is constantly shifting. Fund numbers decline as investors exhaust their capital or poor performance forces them to wind up their activities, and numbers rise when existing managers are successful in raising fresh pools of capital or new managers launch investment products. Equally, the precise composition of the universe of active investors is also fluid. Some cyclical conditions favour certain types of investors over another, as do certain policy initiatives or trends among institutional investors. The number of angel investors, for example, typically falls sharply in the immediate aftermath of a financial market downturn. In contrast, there might be significant increase in the number of venture capital trusts (VCTs) in the light of beneficial changes to their tax treatment.

3.2 The identity of many of the investors targeting this part of the market also often changes over relatively short periods of time. Successful fund managers find themselves in the position of being able to raise larger pools of capital for follow-on funds, thereby raising their investment target and moving away from the SME sector. But poorly performing managers are often unable to raise new funds and thus withdraw altogether. The significance of these phenomena is that while the aggregate number of active funds might remain relatively stable over time, the composition is likely to be very different. This, in turn, will have implications for the aggregate supply of capital, the density of fund populations in given regions, and the sector and stage interests of the population at large at any moment in time.

Identifying the active universe of investors

Chart 1: Identification of active investors in SMEs

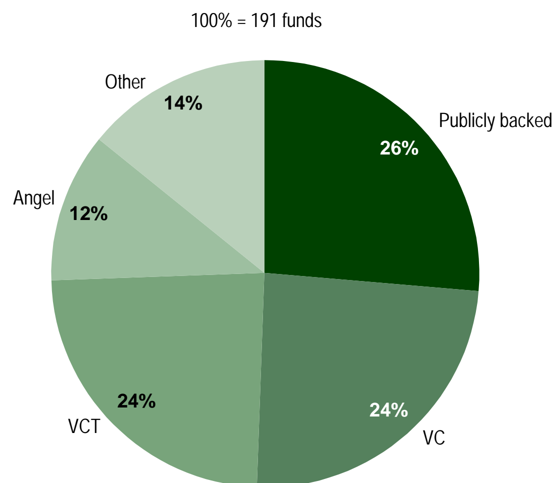


Source: Almeida Capital research

3.3 Chart 1 shows the funds that were originally targeted for this study on the grounds that they have historically been active in the appropriate areas. Further investigation, however, established that of the 261 initial targets there were 70 that did not meet the requisite criteria of being systematic investors, from seed to growth capital, in SMEs in England during the period 2003 to 2004. Some 31 had refocused their activities in line with the diminishing appetite for risk and an expectation that it would be easier for them to return to the institutional capital markets with a predominant buy-out focus than with a venture focus. But perhaps more significantly, some 39 had withdrawn because they ran out of capital and were unable to refresh their supply.

Breakdown of active funds

Chart 2: Breakdown of active funds by type



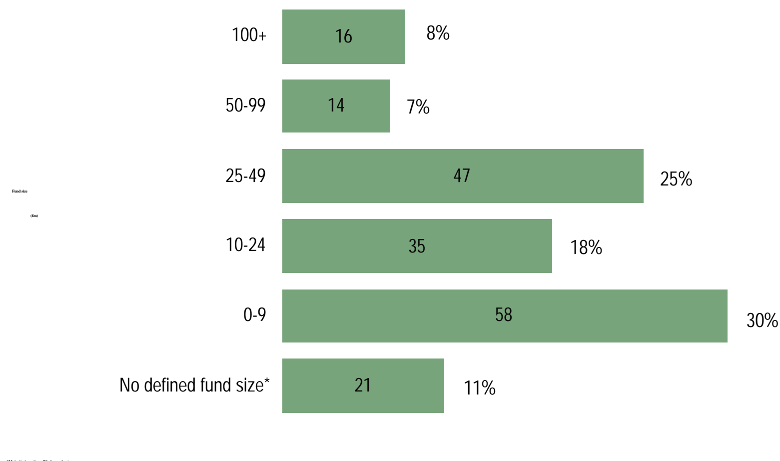
Source: Almeida Capital research

3.4 The study has identified 191 active funds being managed by some 131 investment firms. In some instances a single firm manages as many as ten different funds, while in others they have just one active fund under management. Each of them has been systematically investing in SMEs in England during 2003 and 2004.

3.5 The largest group is composed of the 50 publicly-backed funds, which account for 26 per cent of the population. The study further breaks down publicly-backed funds into those that are wholly and those that are partly funded by public sector bodies. Some 34 or 68 per cent are partly publicly-backed and 16 or 32 per cent are wholly publicly-backed. The next largest category is made up of the 46 independent venture capital firms (VCs), which account for 24 per cent of the population. The 45 VCTs also account for around 24 per cent of the active population. 'Other' funds account for 14 per cent of the active population and the 22 angel networks for 12 per cent.

The size of funds

Chart 3: Number of funds by size of fund



Source: Almeida Capital research

3.6 The size of the funds covered by this study varies from little more than £1m at the bottom to around £375m at the top. And a very small number of firms, such as 3i, have a theoretical capacity in the form of a large balance sheet that is the equivalent of an even bigger fund. The subject of fund sizes will be dealt with in more detail in chapter five but it is worth taking a brief look at the composition of the universe by the size of their funds to provide some context for what follows. Chart three shows clearly that the very largest funds represent only a small proportion of the active population. Most of these are true VCs but some of them are balanced funds that invest in both early stage and buy-outs. The majority of active investors, some 73 per cent, are investing from funds of less than £50m and nearly half have funds of less than £25m. This will inform the size of transaction they can realistically undertake, the number of deals they can do and their capacity to provide further rounds of finance, where that is required. There is, however, a significant difference in the number of investments made by different funds, even where they are investing at a similar stage. This will be explored in more detail in chapter six.

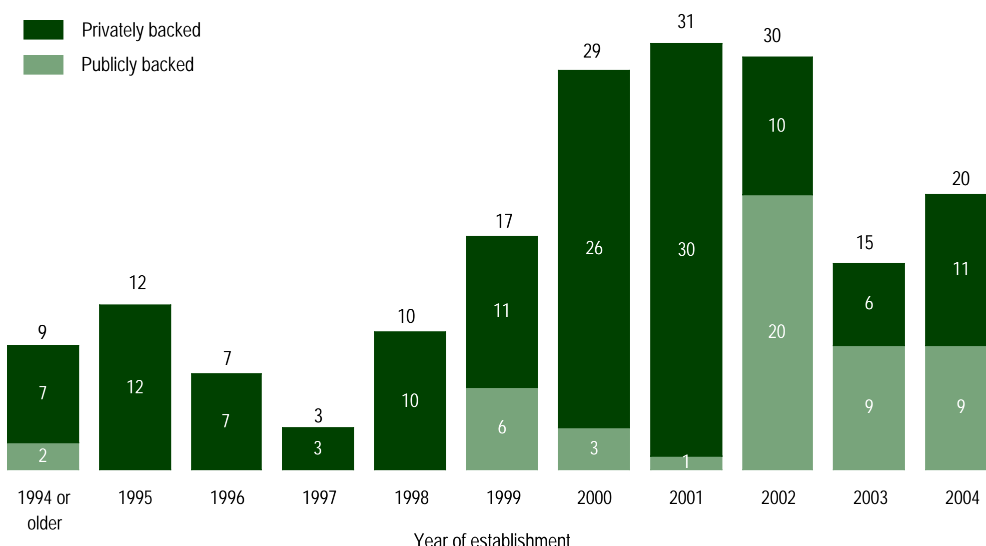
3.7 (Estimates for the size of funds exclude those investors who are investing from their balance sheet or do not have a specific, ring-fenced pool of capital. They also do not include venture firms that invest on a deal by deal basis, drawing capital from their investors only when necessary rather than securing commitments in advance of investing.)

The age of funds

3.8 The last ten years have seen three moments of rapid fund formation, each one explained by different drivers. The first was the introduction of VCTs in the mid-1990s, which triggered the establishment of a large number of qualifying funds. The second was the “irrational exuberance” of the late 1990s’ technology bubble, which married the thirst for venture investment of the

institutional community with the hopeful ambition of a new wave of venture firms. The third was the government-sponsored creation of first UCSFs and then the RVCFs and EGFs. Chart 4 shows how each of these moments is reflected in the present population of active investors. However, the limited investment life of most funds, VCs in particular, means that the large number of funds that were raised in the late 1990s and have now completed their investment phase are not captured because they do not meet our definition of being 'active' investors in 2003 and 2004.

Chart 4: Active funds, by year of establishment



Source: Almeida Capital research

3.9 The spike of privately-backed funds established some ten years ago marks the first wave of VCTs. A significant number of VC funds were raised in the three years that followed but only a very small number of them, as shown by the chart, are still active. Most VCs have an investment period of five or six years, explaining the drop off rate. VCTs, in contrast, are evergreen, so that even though they generally have an intense three-year period of investing after launch, they can continue their activity once they have begun realising earlier investments. There was another wave of fundraising in 2000 and 2001, before the full ramifications of the implosion of the venture bubble had become clear to investors. Many but not all of the funds that were raised during this period are still active. Most managers dramatically slowed their investment pace from 2000 onwards, reflecting the widespread uncertainty about the outlook for public markets. They were also highly sensitive to the newfound institutional scepticism in the immediate aftermath of the bubble. There was a conspicuous emphasis on discipline, investment strategy, and rigorous due diligence.

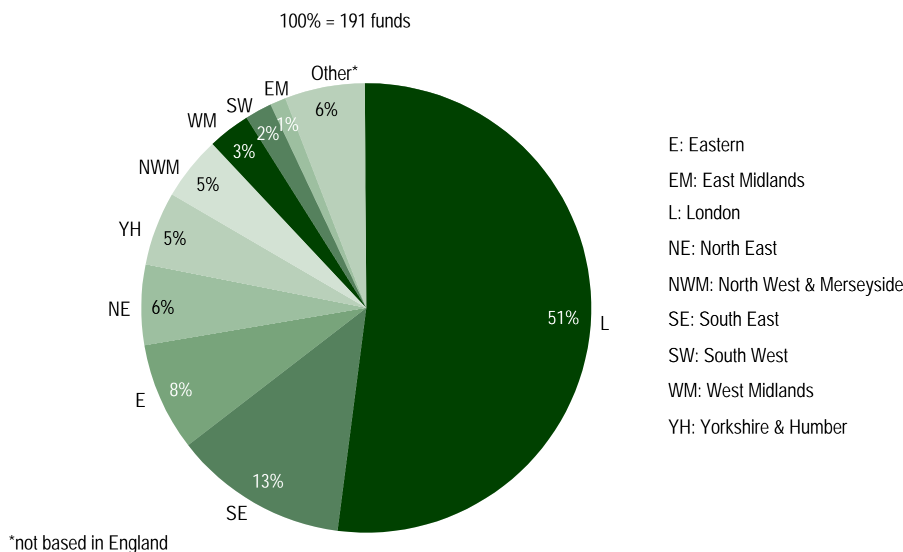
3.10 Publicly-backed funds have made up more than half of all the new active funds in the last three years. The largest of these were RVCFs but there were a handful of other new initiatives that reflect the recent emphasis on providing private equity or venture finance to SMEs as a way of furthering public economic goals. These have

included broad new categories of funds, such as the Early Growth Funds, as well as one off creations such as the Recycling Fund.

Regional analysis

Location of funds

Chart 5: Location of funds



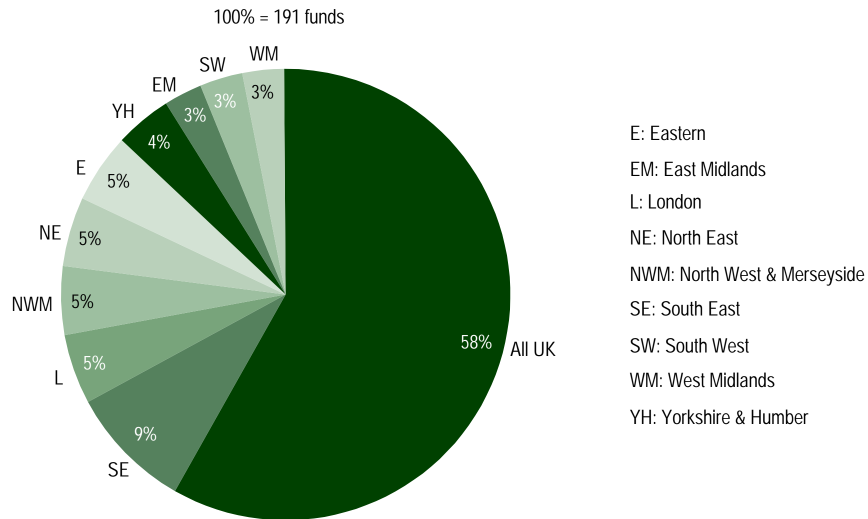
Source: Almeida Capital research

3.11 Some 51 per cent of active funds by number are based in London, making it by far the largest depository of funds in England. This is driven much more by its importance as a source of capital than as a source of deal flow (see chapter eight), although it may have consequences. A number of respondents to the survey made the point that investment decision-making, especially on smaller transactions, was clearly affected by the proximity of the investment proposition. It was hard to persuade a fund manager to travel from London to the north of the country for a small deal when he was likely to be confronted by a string of similar opportunities much closer to home. “Most investors feel that if they can find deals in the South East or London then it’s a lot easier,” said one VC. This geographical distortion is intensified where the investor has ambitions to play an active role in their portfolio companies. It was an appreciation of this phenomenon that informed the government’s decision to locate funds in the different regions and to stipulate their regional focus. It overcomes the inertia of London-based managers.

3.12 Outside of London, there is a closer correlation between the number of funds in a region and the volume of investment activity.

Regional focus

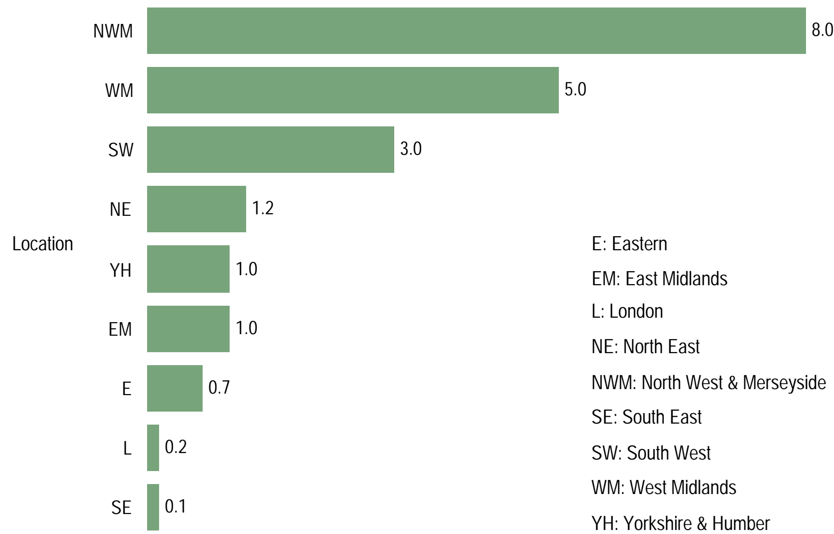
Chart 6: Breakdown by regional focus



Source: Almeida Capital research

3.13 Some 58 per cent of active funds do not have a specific regional focus. This is roughly matched with the proportion of funds located in London. They tend to have a broad multi-regional, indeed often pan-European remit from their investors. The breakdown of the funds with an explicit regional focus is also closely matched to the location of funds. The notable exception is funds focused on London, which account for just five per cent of the population. The South East accounts for the largest share of regionally-focused funds, with nine per cent of the total. This is partly explained by the fact that the South East is home to a large number of regionally-focused angel networks, reflecting its relative prosperity. It is also home to a number of universities or groups of universities, many of which have UCSFs. No other region has more than five per cent.

Chart 7: Ratio of publicly to privately-backed funds by location



Source: Almeida Capital research

3.14 There are significant differences in the composition of local populations of funds in the various regions. Some regions have more publicly-backed funds than privately-backed funds, while in some regions this relationship is sharply inverted. Chart 7 shows that the North West and Merseyside and the West Midlands have the densest population of publicly-backed funds, followed closely by the South West. In general, this relationship is a function of both the number of all types of funds in a region and the decision on the part of the UK government and the EU through its ERDF to support activity in the given region. So the lowest ratio of publicly backed to privately-backed funds is the South East, followed by London, both of which benefit from being the most populous in terms of all types of funds.

Summary

3.15 "It is an inescapable pattern of life in this industry that the guys who do badly drop out and the guys that do well raise more money and move up. So you have to work out a way of keeping people in this bottom part of the market," said a VC manager.

3.16 The population of venture providers is constantly shifting, both in size and shape. At present, there are some 191 funds being managed by 131 different firms. Some 26 per cent of them are publicly-backed, 32 per cent wholly and 68 per cent partly, highlighting the importance of the public sector in the instigation of new funds in recent years. Privately-backed funds, in contrast, have suffered an extremely unsympathetic fundraising environment since 2001.

3.17 The regional distribution of the location of funds is heavily weighted in favour of London, which is home to roughly half of all active

funds. But this is a function of its importance as a source of capital rather than as a source of deal flow and there are funds with a specific regional focus spread more evenly around the country. Again, the public sector has been the main driver in the creation of regionally-focused funds, accounting for 62 per cent of them. Privately-backed funds, with the exception of angel networks, are almost always pan-regional.

4

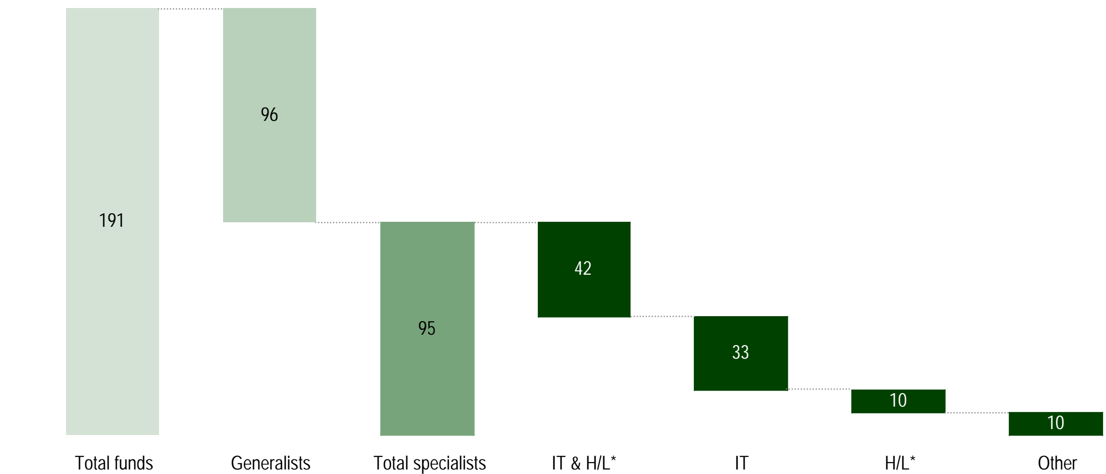
Specialists and generalists

4.1 Just under half of all the active funds in England are specialists, meaning they limit their investment activity to a few key sectors. These are typically sectors that require a high degree of expert knowledge because the technology risk is particularly high and the target opportunities are not yet sufficiently developed to present a meaningful commercial profile. Very often the targets are still a long way from producing a positive cash flow and their attractiveness as an investment proposition depends on an informed judgement about the potential of the technology rather than a judgement about business competence.

4.2 Generalist funds will sometimes invest in specialist sectors but usually when the businesses are at a later stage and the technology risk has been mitigated. Or they will seek to partner with a specialist investor who can provide them with confidence in the technology. However, the very different risk profiles of specialist and generalist investing mean there are typically quite significant differences in the way the two groups behave. Their behaviour is also affected by the prevailing appetite and attitudes of institutional investors, who provide them with their investment capital. The relatively fresh experience of the implosion of the venture bubble, for example, has had a much bigger impact on technology specialists than on generalists.

Breakdown of funds by specialisation

Chart 8: Breakdown of funds by specialisation



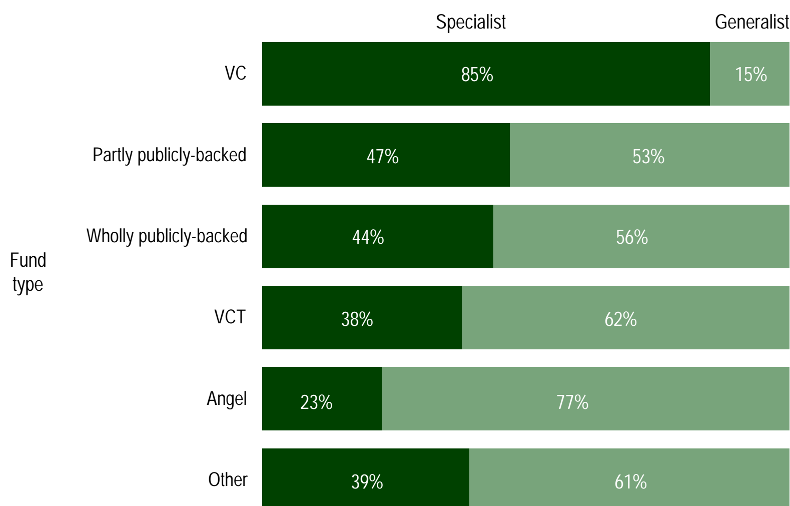
*H/L: Healthcare/Lifescience

Source: Almeida Capital research

4.3 There are 95 active specialist funds and 96 generalist funds. (See chart 8.) Of these, the largest group are firms with a combined IT and life science specialisation, accounting for 42 firms. The next largest group is the pure IT specialists. There are a further ten pure life science investors. The remaining ten firms have specialisations in other sectors, such as media, energy, or truly niche sectors such as recycling.

Specialisation by fund type

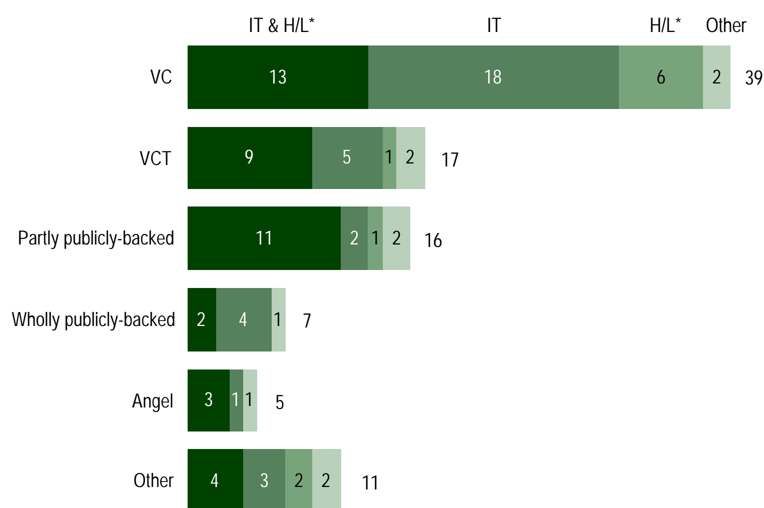
Chart 9: Fund types: Specialist and Generalist



Source: Almeida Capital research

4.4 The main body of specialists are venture capital firms. Indeed, some 85 per cent of all VCs are specialists, reflecting the fact that they are the preferred means for institutional investors to channel their capital into high risk technology sectors (see chart 9.) The increasing incidence of specialisation among VCs has been a gradual phenomenon since the earliest days of the industry in England during the late 1970s and early 1980s but became commonplace towards the middle of the 1990s. This mirrors the development of the venture industry in the US, albeit with a lag of as much as twenty years or more, where the split between specialist VCs and generalist private equity investors has long been commonplace. The significance of the split has become sufficiently entrenched in the minds of institutional investors that many generalists now explicitly state they will not invest in technology businesses. They recognise that institutions do not want their capital invested in specialist sectors by generalists. Of the 39 specialist VCs, 18 of them are IT focused, 13 combine an IT and a life sciences focus, and six are purely life sciences focused. (See chart 10.)

Chart 10: Fund types by specialisation



Source: Almeida Capital research

4.5 The next largest category of specialist funds is the publicly-backed funds. Some 16 or 47 per cent of them are specialists, of whom the large majority are university challenge seed funds. Eleven of them have a combined life sciences and IT focus, two have a pure IT focus, one a pure life sciences focus and two have a focus on other sectors. The RVCFs do not have specialist focuses, although some of them have made technology investments. By and large, the limit on the size of investment they can make prohibits them from investing in technology because it generally requires greater capital capacity. They also lack the resource to pay for the technical skills needed for effective specialist investing. Seven of the wholly publicly-backed funds, or 44 per cent, are specialists.

4.6 Some 38 per cent of all VCTs, or 17 funds, are specialists. Five of the specialist VCTs have an IT focus, nine a combined IT and life

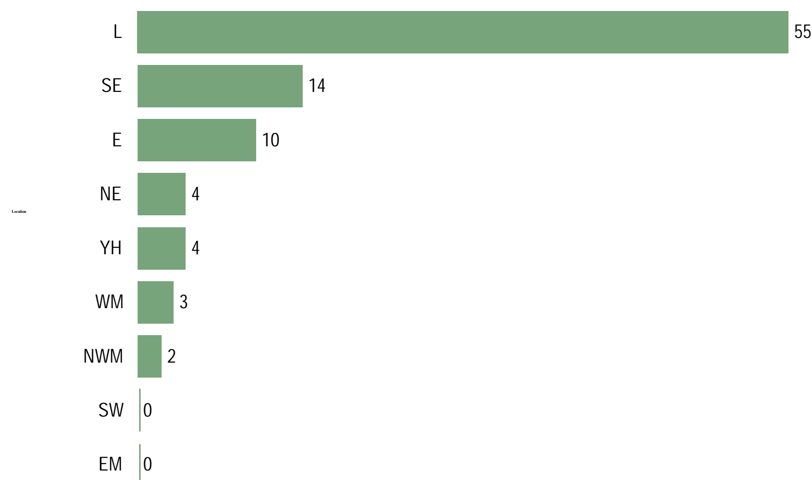
sciences focus, one is pure life sciences specialist and two are media focused.

4.7 Angel networks do not generally have specialisations although there are a small number of exceptions. The likelihood of the network having a specialisation is generally dictated by its location. So the networks around Cambridge and Oxford, typically composed of academics and business people in the area, are more often specialised because they have been established to back technologies emerging from the academic institutions. Elsewhere, the networks are more commonly composed of local business people, whose expertise and thus comfort zone is with commerce rather than technology.

4.8 There are eleven specialists among the other funds, 39 per cent of the total. These are generally the corporate venturing units of companies that are active in the technology or life sciences industries. Their main motive for investing is typically strategic and thus their investment focus tends to be allied to the parent's core activities.

Location of specialists

Chart 11: Location of specialists*



Source: Almeida Capital research

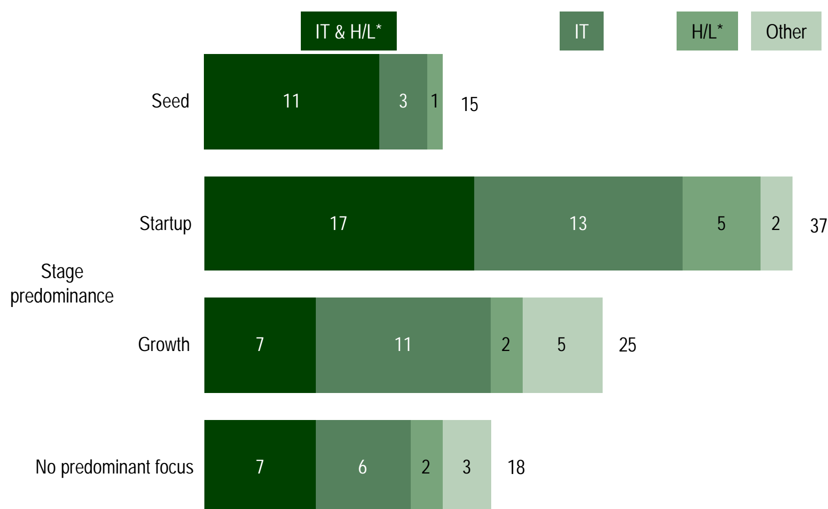
4.9 The ambition of specialists, wherever their interests lie, is to back the most commercially promising technologies. The geography of these technologies is incidental, except when dealing with very early stage or seed investors covering specific research establishments. So the location of specialist investors tends to be influenced more by their source of capital than the much more diverse sources of their deal flow. Chart 11 shows that 55 of the active specialists are based in London, albeit they invest throughout England and often throughout continental Europe. There is also a significant population of specialists in the South East and in the Eastern region. In both instances, these specialists tend to be early stage focused

investors taking advantage of the deal flow from the technology clusters of Cambridge and the Thames Valley.

4.10 The only regions where more than half of the population of active funds are specialists are London, the South East and the Eastern region. Elsewhere, specialists are in the minority. The extreme is represented by the South West and the East Midlands, where there are no specialist funds. Fund managers argued consistently through the course of interviews that the location of the fund is irrelevant because skilled funds will identify the most promising technologies irrespective of where they based. The only exception is at the earliest stage where technologies often require some seeding before they are in a position to demonstrate any commercial potential. This condition is provided for by the existence of the UCSFs and, to some degree, by local angel networks. The question of a regional technology equity gap will be addressed in more detail in chapter eight.

Stage predominance of specialists

Chart 12: Stage predominance by specialist



Source: Almeida Capital research

4.11 Specialist funds have historically had an early stage focus. Technology risk is higher at that point in the life cycle of their investment targets so their specialist skills are of greater value. Almost a third of specialist funds, however, have been investing predominantly at the growth stage over the last two years.

4.12 As discussed previously, one of the consequences of the implosion of the venture bubble and the resulting financial discomfort was to push investors of all sorts to the lower end of their respective risk spectrums. This meant in the case of a lot of VCs that they reduced or even abandoned their true early stage investing and concentrated instead on supporting the development of existing portfolio companies or increased their focus on later stage businesses that were closer to achieving an exit. The pressure to

perform well enough to be able to raise another fund will always have the effect of altering investment behaviour when the financial environment changes. "There is definitely a trend for a lower appetite for seed and series A investing. It's all about the financing risk. Everyone wants to invest in the last round before IPO. Getting follow on financing has become extremely difficult in the last few years and it's pretty extreme now. Our working assumption is that it is not going to get any better," said one life sciences specialist. The data gathered for the purposes of this study is intended to provide a snapshot of activity rather than a historical perspective on stage predominance but it is clear from the comments of many venture firms that there has been a pronounced shift in stage activity in recent years.

4.13 There is an exception in the form of the publicly-backed specialists, mainly the UCSFs. They have remained predominantly seed or early stage investors, largely because their terms limit the upper size of investment they can make, thus denying them the option to adjust their strategy to take account of the financial cycle. Some of their managers, however, said they had been able to respond to a more unsympathetic exit environment, and thus the risk of a collapse in future capital supply, by slowing the pace of investment activity and adopting new screening procedures.

Summary

4.14 The population of active funds is split almost half and half between specialists and generalists. This reflects a now commonplace recognition that successful technology investing, and other specialist sectors, requires significant input from professionals with the relevant technical skills. Specialist funds, most of which are VCs rather than any other fund type, tend to be concentrated around the source of capital rather than the supply of deal flow on the basis that the best technology transcends geography. But there are also a number of specialists based around the major technology clusters in the South East, London and Eastern region.

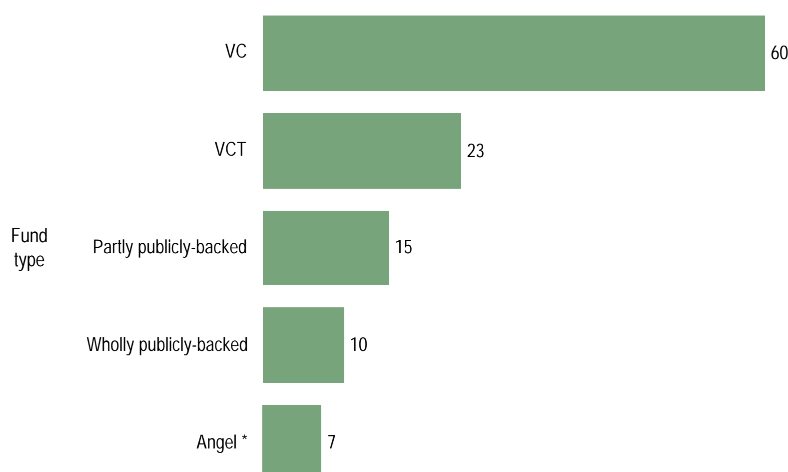
4.15 Historically, specialists have had a focus on early stage investing but recent years have seen a shift towards the later stages as a means of mitigating risk. The study found that more than a third of specialists had been investing predominantly at growth capital stage during 2003 and 2004. This pattern is less pronounced among publicly-backed specialists, mainly the UCSFs, which are limited in the size of investment they can make and thus have less flexibility to adjust their strategy to the financial cycle.

5

Fund Sizes and Sources of Capital

Fund Sizes

Chart 13: Average size of fund, by fund type (£m)



Source: Almeida Capital research

5.1 The largest funds are typically managed by VCs. Their average size is £60m, compared with just £23m for VCTs, £15m for partly publicly-backed funds, £10m for wholly publicly-backed funds and £7m for angel networks. (Angel networks do not invest out of funds but it is possible to estimate an equivalent fund size by multiplying their annual investment capacity by five, the average investment period for conventional funds. Equally VCTs are evergreen vehicles rather than of a predetermined life but their regulations stipulate a concentration of their activity in a roughly comparable way with the other funds.)

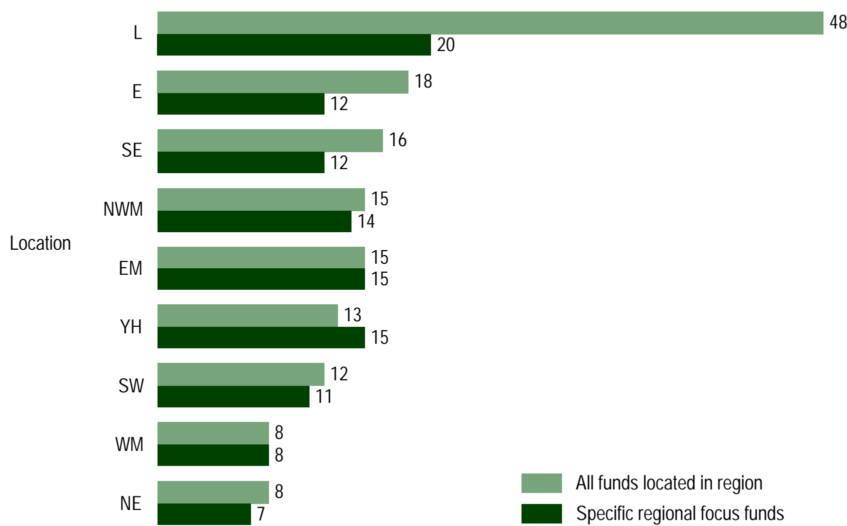
5.2 VCs are much larger than the other funds because they raise their capital from institutional investors, who are much better supplied than the other sources. Insurance companies, funds of funds, pension funds, and to a lesser extent large companies and banks, are all capable and familiar with making commitments to a single fund of more than £5m. Indeed, some of the larger institutions will not make commitments of less than £20m because the size of their portfolio is such that smaller fund investments, even if their

performance were outstanding, would not make a detectable impact on their overall returns.

5.3 On average the angel networks represent the smallest average (equivalent) fund size of just £7m but they vary dramatically in their investment capacity. Some of the RDA-backed networks have made relatively few, small investments and thus, while their capacity might be greater, their equivalent fund size is sometimes less than £1m. A small number, by contrast, have an equivalent fund size of more than £20m. Their average size, however, is commensurate with their focus on early stage and often seed investing.

Fund sizes by location and regional focus

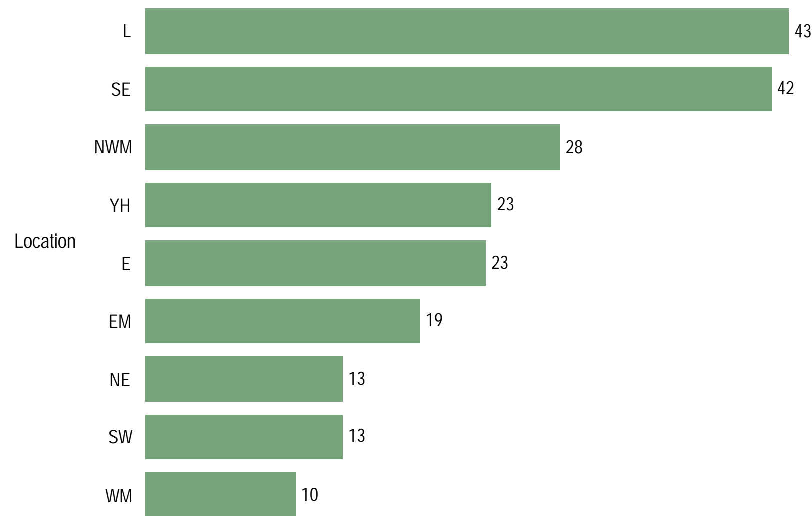
Chart 14: Average fund size by location (£m)



Source: Almeida Capital research

5.4 The London-based funds are significantly larger on average than the funds in any other regions. Once again, this reflects the fact that most of the VCs are based in the capital. At the bottom end of the range, the average size of funds located in the West Midlands and the North East is less than £10m and the funds focused on investing in those regions are similarly small.

Chart 15: Annual supply of capital from regionally-focused funds (£m)

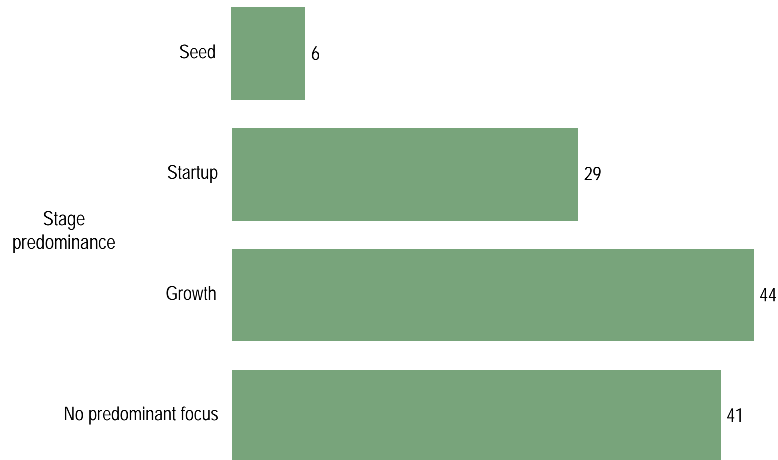


Source: Almeida Capital research

5.5 Chart 15 provides an estimate of the annual supply of capital to each region from regionally-focused funds. It is calculated by dividing the total capital under the management of such funds by five, which represents the average investment period for funds. The supply of capital from angels is estimated from the average annual value of their investment over the study period. The result shows that London, the South East and the North West and Merseyside are the best supplied, while the North East, South West and West Midlands have the smallest supply. This does not necessarily imply any imbalance between supply and demand because a very substantial proportion of total capital is managed by funds with no specific regional focus. In other words, there is a large pool of capital that can, in theory, respond to demand wherever it might be.

Fund sizes by stage predominance

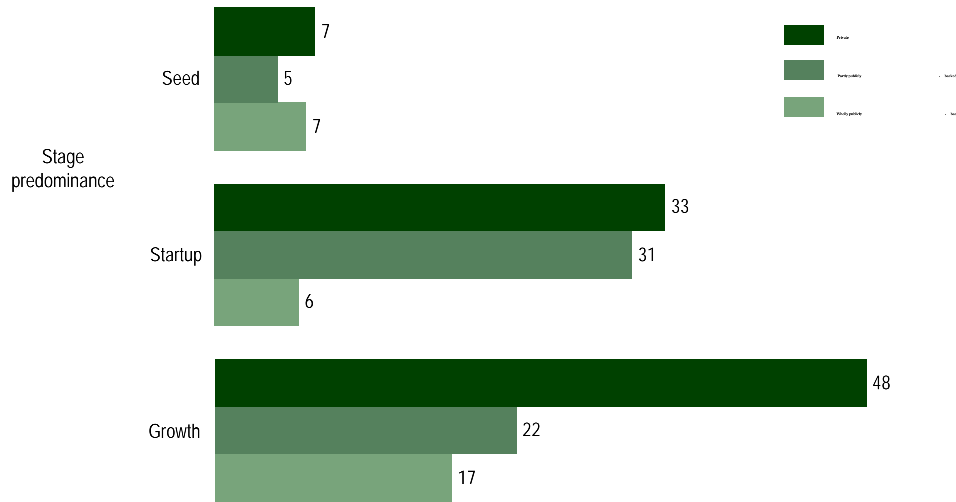
Chart 16: Average size of fund by stage predominance (£m)



Source: Almeida Capital research

5.6 There is clearly some sort of correlation between fund size and the stage predominance of the fund. After all, growth capital deals are generally larger than start-up deals, which are in turn larger than seed deals. Chart 16 shows a significant difference between the average fund size for firms predominantly investing in growth deals and those predominantly investing in start-up deals. The average fund size for funds with no stage predominance reflects the varied activity in recent years of many venture firms, which typically have the largest fund sizes. Whereas they have historically had an early stage focus, a greater part of their activity in the most recent period has been on later stage investments.

Chart 17: Average size of fund by stage predominance: Publicly and Privately-backed (£m)



Source: Almeida Capital research

5.7 The influence of VCs on the average fund size by stage predominance is more pronounced when the publicly-backed funds are stripped out of the calculations (see chart 17). The average seed fund is considerably smaller than both growth and start-up funds, irrespective of being publicly or privately-backed.

Fund sizes for generalists and specialists

Chart 18: Average size of fund: Specialist and Generalist (£m)

Source: Almeida Capital research

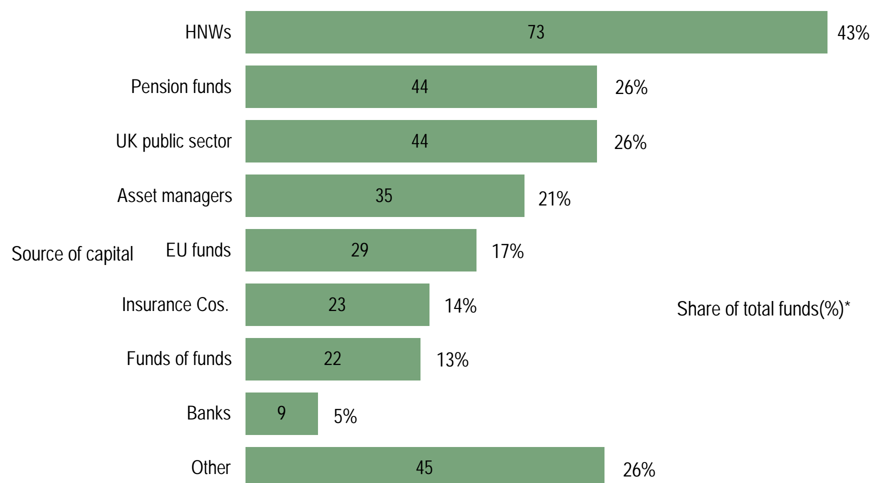
5.8 The average specialist fund is two and a half times the size of the average generalist fund, reflecting the fact that the majority of them are managed by VCs. Average fund size targets for VCs have declined since the 'dotcom' period but they remain larger than

generalist funds because of the capital demands of building technology or life science businesses.

Sources of capital

Funds by source of capital

Chart 19: Sources of capital, by number of funds in which they are invested



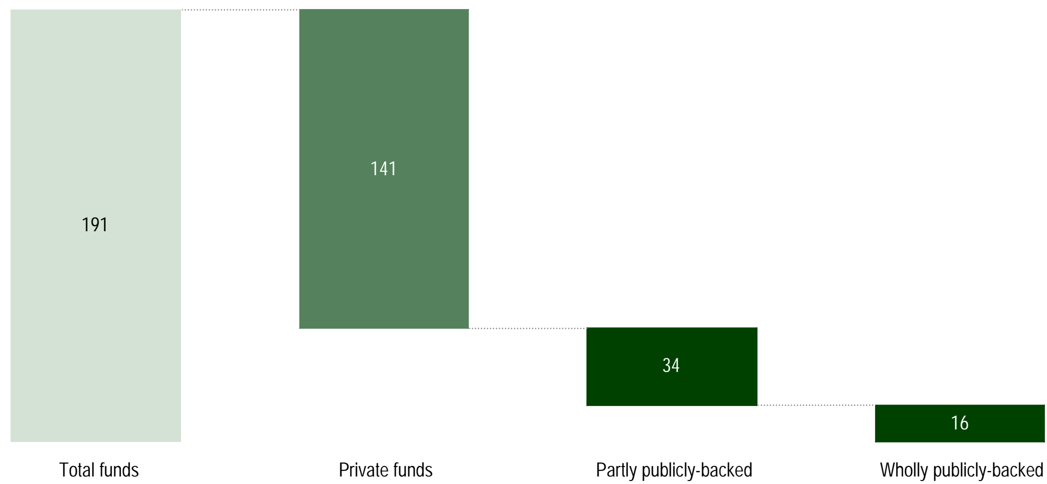
Source: Almeida Capital research

5.9 High Net Worth (individuals) are invested in more funds than any other category of investor. (See chart 19.) This does not mean, however, they contribute the greatest quantity of capital to the universe of funds because their contributions are generally much smaller than those made by institutional investors. The main recipients of HNW capital are angel networks and VCTs, which are generally much smaller than VCs or the publicly-backed vehicles. Pension funds are the second most active investors in funds. Local authority pension funds are also often investors in the RVCFs, which has helped swell their prevalence as investors. Pension funds are closely followed by the UK public sector. Some 26 per cent of active funds have received UK public sector capital, which in almost every instance primed the fund's existence.

5.10 The other major institutional investors are asset managers, funds of funds, and insurance companies. This group as a whole, including pension funds, is driven in its investment decision-making by performance, being accountable for the returns to their own shareholders or investors. As a rule they are only invested in the VCs rather than any of the other providers of finance covered by the study, reflecting their view that these are the most effective vehicles through which to get their exposure to investing in SMEs. The 'other' category is composed of banks, endowments, and some charities, most of whom have invested in the partly publicly-backed funds.

The UK public sector as an investor

Chart 20: Breakdown of funds with some public sector capital



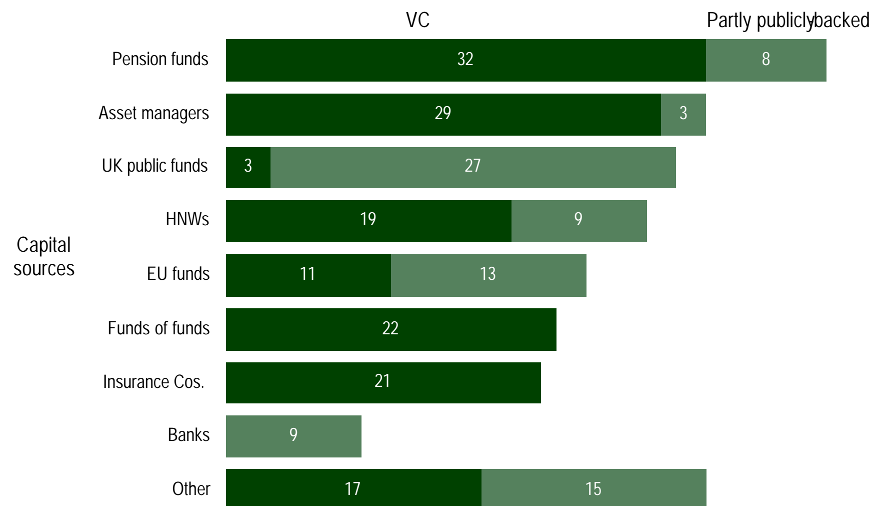
Source: Almeida Capital research

5.11 The UK public sector is an active investor through a number of bodies. The RVCFs, for example, are funded by the Department of Trade and Industry, the UCSFs by the Office of Science and Technology, and a handful of other funds by the Office of the Deputy Prime Minister. In aggregate, the public sector has invested in 50 of the active funds, of which 34 have also received private sector investment.

5.12 Where the government has provided only part of the capital the private sector is typically the majority investor. The RVCFs, for example, generally received about 25 per cent of their funds from the government and the rest from private sector investors. The public sector, however, is much more than simply a minority investor, not least because of its subordinated position, and should be considered a cornerstone or enabling source of capital. In other words, the fund is a tool of economic policy even if its resources have been leveraged by the private sector.

Sources of private sector capital in publicly-backed funds

Chart 21: Number of funds backed by different sources of capital



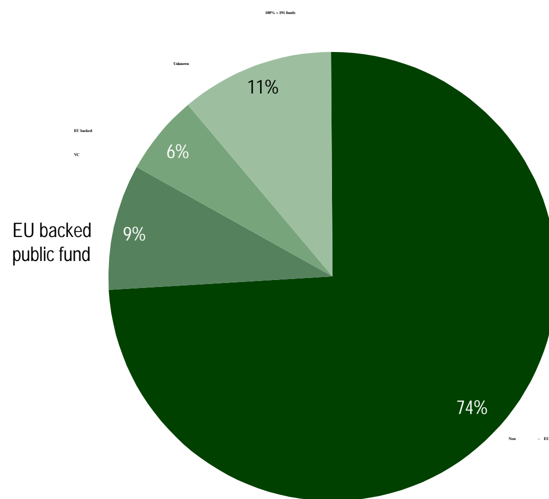
Source: Almeida Capital research

5.13 Analysis of the composition of private sector capital in publicly-backed funds is instructive because it differs considerably from the sources that provide most of the capital to VCs and other privately-backed vehicles. Publicly-backed funds have received little if any money from the corporate pension funds, asset managers, insurance companies, and funds of funds that are the major source of institutional capital in private equity. (See chart 21.) Most private investment in publicly-backed funds has been raised from banks and local authority pension funds in the case of the RVCFs, and universities and charitable endowments in the case of the UCSFs.

5.14 The absence of major institutional capital from publicly-backed funds might be interpreted as meaning the institutions do not consider these funds to be the most effective way of getting exposure to the SME sector. Certainly the investment strategy of many of the RVCFs is in marked contrast to the way VCs typically invest in the sector. These differences will be explored in greater detail in subsequent chapters. But the real importance will lie in future attempts by these funds to raise subsequent financing from the major suppliers of capital to the asset class. In the absence of further public backing or more money from their existing private sector investors, these are the institutions from which they will be required to source their capital. In such a case, they will be competing on level terms with VCs not just active in England but from around the globe. In the extreme, it could mean, for example, pitching themselves against some of the outstanding, long-established Silicon Valley venture funds, whose returns over time have been amongst the best in the asset class. Thus, past performance and fees may be key factors.

Sourcing capital from EU bodies

Chart 22: Proportion of funds with EU funding



Source: Almeida Capital research

5.15 EU funds are also significant investors in active funds, backing 15 per cent of the population. Some of these funds are wholly funded by the EU, generally benefiting the Objective II regions through the European Regional Structural Development Fund. Their aim is explicitly to stimulate activity in the weakest economies. But the EU has also funded a number of funds through the European Investment Fund, a division of the European Investment Bank. These include both the RVCFs and also some VCs.

Summary

5.16 The largest funds are managed by VCs and are typically more than three times the size of other fund types. They are predominantly investing in technology sectors, which are highly capital intensive and require large amounts of money to build profitable businesses. The high risk of investing in technology also requires a diversified portfolio, with the combined effect that fund sizes need to be large if they are to achieve the desired effect of returning a multiple of capital invested. The size premium of VC funds is reflected in London's large share of the value of total funds but there are less profound regional differences in the annual supply of capital from regionally-focused funds. London, the South East and the North West and Merseyside are the best supplied with focused capital, while the North East, South West and West Midlands are the poorest.

5.17 The much bigger size of VC funds is also a function of the sources of their capital. Their money is typically raised from institutional investors – pension funds, insurance companies, asset managers and funds of funds. These institutions have only very limited exposure to other types of funds, which tend to draw their capital from retail investors, HNWs, or banks. (There has been some investment by local authority pension funds in RVCFs but the quantities are not large by comparison with the VCs.) This could have profound implications for the publicly-backed funds' ambition

to become self-sustaining over time because it suggests they have, as yet, been unable to build relationships with the largest sources of capital. Their ability to do so in future will require them to compare and compete favourably with VCs, who presently have a near monopoly as the preferred means of institutional investors to get exposure to the SME sector.

6

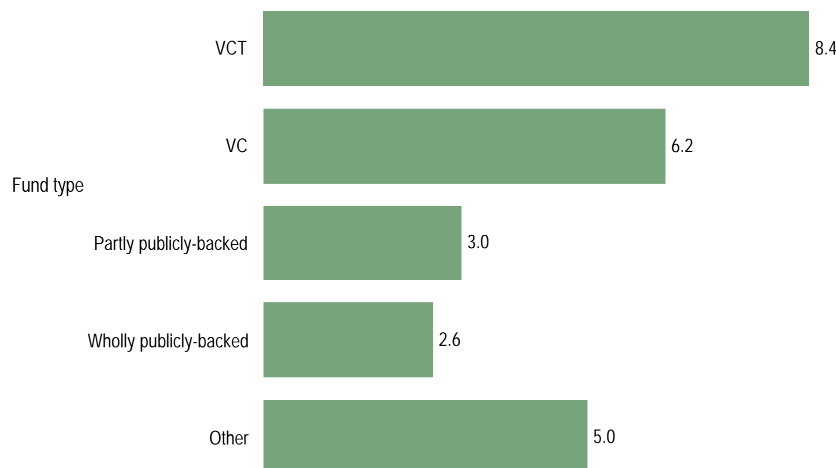
Analysis of teams

6.1 The size and composition of the team both reflects and enables the investment strategy of a fund. Large teams are generally better equipped to maintain a higher pace of investment or to spend more time working with portfolio companies. Smaller teams do not typically have the capacity to play active roles with their investee companies and do not have the deal screening capabilities of larger firms. But given that every fund has slightly different approach and strategy to achieve their performance ambitions it is obviously the case that size is not a good thing per se. What matters is the composition of the team in relation to the strategy; how well the two are aligned. The teams managing the active funds in England vary in size from one to considerably more than ten, reflecting the significant difference in their ambitions and strategies.

Team size

Average team sizes

Chart 23: Average size of team (investment professionals) by fund type



Source: Almeida Capital research

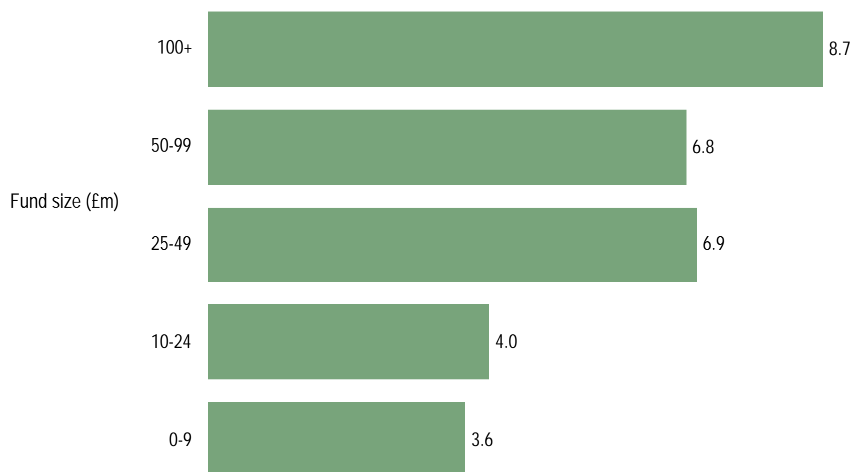
6.2 The size of team reflects the number of full-time investment professionals and excludes support staff. The largest teams work on VCTs, averaging over eight professionals. These professionals are generally managing several funds in parallel and so the figure perhaps overstates their privileged resource. But the survey showed a tendency among VCT managers to invest from a series of funds in single investments, thus treating them almost as if they were a

single source of capital, means there is a near equivalence with single fund managers. VCT funds are also usually part of a bigger asset management business, which means they often benefit further from resource shared with the parent. VCs have an average team of just over six investment professionals. By contrast, the partly publicly-backed funds have an average team size of around three.

6.3 One of the key determinants of team size is the fund's ability to pay for investment professionals. The cost is generally covered by an annual management fee that, at least among VCs, is related to the size of the fund and falls somewhere between 1.5 per cent and 2.5 per cent of the size of the fund per annum. The greater the number (and thus the value) of funds under management the greater the ability of a firm to pay for investment professionals; so-called 'fee stacking'. This excludes additional remuneration through a share of the fund's carried interest or profit. This performance related compensation has historically been one of the major attractions of working for a VC.

Teams and fund size

Chart 24: Average size of team (investment professionals) by size of fund

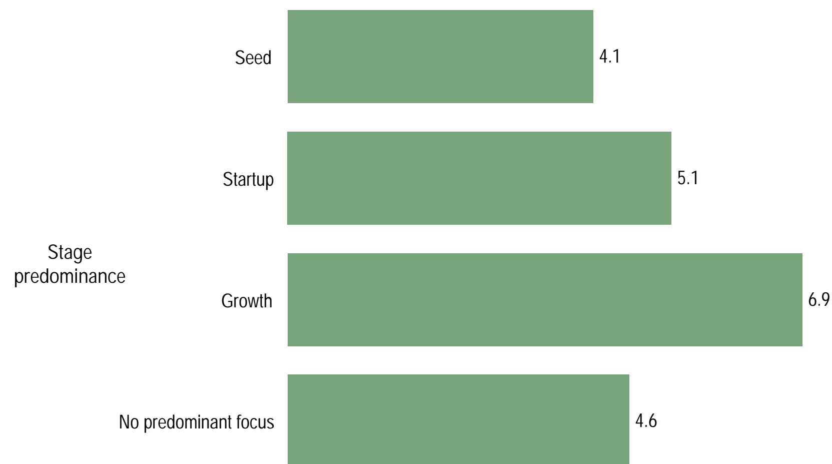


Source: Almeida Capital research

6.4 The biggest funds tend to have the biggest teams but they are not significantly larger than all but the smallest funds. The average team size for funds in excess of £100m is nearly nine, while the average team size for funds between £25m and £99m is almost seven. The smallest funds, however, have significantly smaller teams. This reflects the economic constraints of managing a small fund.

Teams and stage focus

Chart 25: Average size of team (investment professionals) by stage predominance

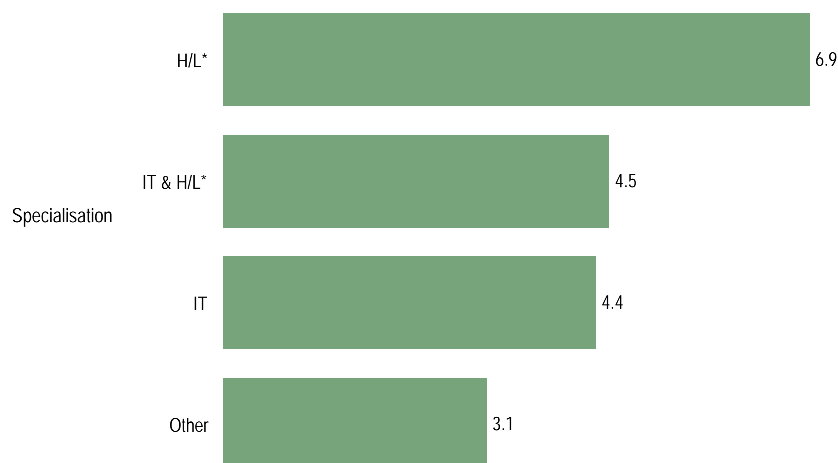


Source: Almeida Capital research

6.5 Funds that invest predominantly in growth transactions tend to have the largest teams. Those with a start-up focus are smaller and seed focused funds have slightly smaller teams again.

Specialist teams

Chart 26: Average size of specialist team by specialisation



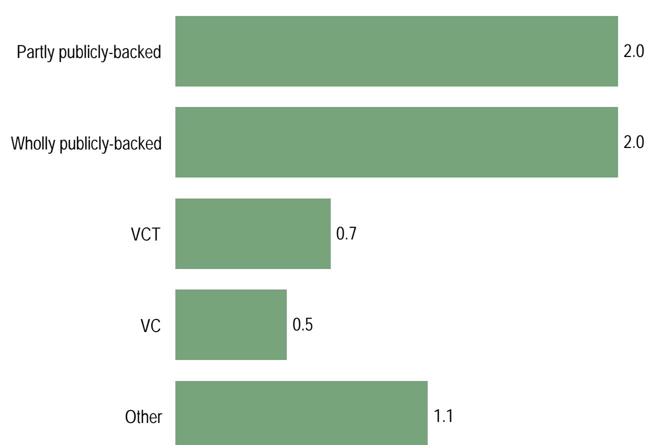
Source: Almeida Capital research

6.6 Life science teams are generally the largest, reflecting the lengthy demands of investing in the sector. The size of specialist teams is obviously not their only important characteristic. The skill sets and the technological capability is at least if not more important. It is a

frequent criticism of European VCs in general that they do not have the same blend of commercial and technology skills that characterise the successful US VCs. During the course of interviews, a number of VC managers complained that there was an acute shortage of experienced professionals in the IT and life sciences sectors. "There really are very few properly qualified technology investors in Europe, guys who know what they are doing and have been doing it for a long time," said one VC.

Team size and investment activity

Chart 27: Annual deals per investment professional by fund type



Source: Almeida Capital research

6.7 More important than the absolute size of a team is the relationship between the number of professionals and the level of their investment activity. Chart 27 shows that investment professionals working on VCTs and VC funds typically do less than one deal per annum. In contrast, professionals working on publicly-backed funds do an average of two per annum.

6.8 This marks a significant difference in the nature of the two groups. At the very least, this dichotomy between the average individual's investment activity is likely to reflect different investment strategy models being employed by the two broad categories of fund.

Summary

6.9 There is not a great difference in the size of teams along the lines of fund size or type, with the exception of the smaller seed teams. There is, however, a big difference in the number of investments per individual at privately and publicly-backed funds. The RVCFs, in particular, have a much higher ratio, more than double, than other fund types.

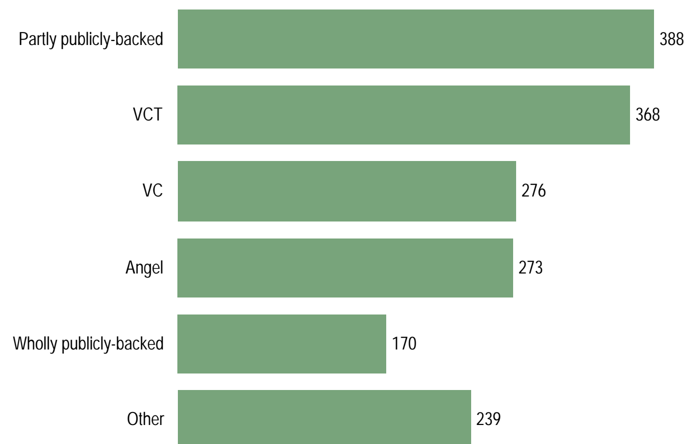
7

Investment Activity

Number of investments

Investments by type of fund

Chart 28: Total number of investments by fund type, 2003-2004



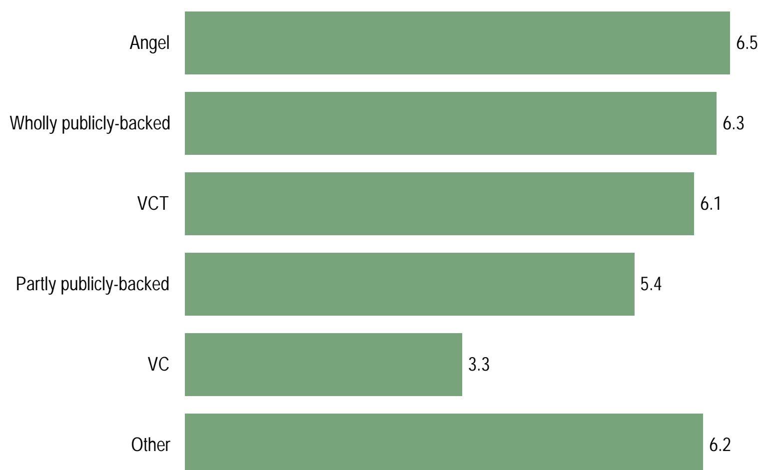
Source: Almeida Capital research

7.1 Publicly-backed funds accounted for nearly a third of all the investments in 2003 and 2004, demonstrating the enormous significance of the public sector in the provision of venture finance to SMEs in England. Together, the partly and wholly publicly-backed funds made 558 investments during the study period. Chart 28 shows that the partly publicly-backed funds were the most active category of investor during the study period.

7.2 The figure captures the number of financings rather than the individual companies that received investment. The difference between these two numbers varies according to the fund type. Publicly-backed funds tend to invest once or possibly twice in the same company over a period of time, and rarely more than once a year. Indeed, they are subject to restrictions on follow-on financing. VCs, in contrast, tend to drip feed their investment. (Their financings are either structured as a series of tranches marked by milestones following a single investment decision, or as a number of individual decisions.) They are also more likely than publicly-backed funds to co-invest as part of a large syndicate, with three or more partners. The publicly-backed funds regularly co-invest but generally in much smaller consortia and most typically with just one other body or a group of angels. These contrasting patterns of behaviour mean that

the publicly-backed funds have backed significantly more companies relative to the number of investments than VCs or VCTs.

Chart 29: Average number of annual investments by fund type

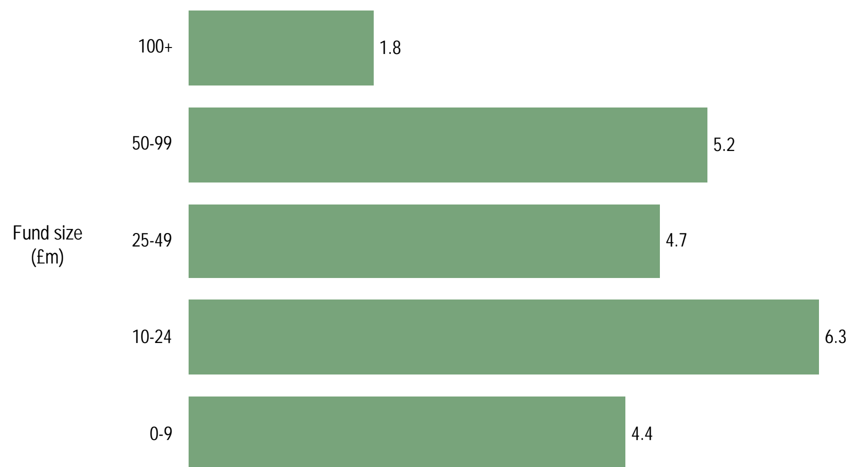


Source: Almeida Capital research

7.3 Angels and publicly-backed funds, chiefly the RVCFs, make on average more investments each year than other types of funds. Indeed, they typically make more than twice the number of investments of a VC. For RVCFs, this is probably a consequence of the limit on the size of their investments, initially up to £250,000 and then no more than £500,000 per company. A fund of £20m, for example, can back a minimum of 40 companies, on the assumption that each receives the maximum permitted amount of funding. The fund has a ten year life, of which five is intended as the investment period and five as the divestment period. The limit on maximum investment means the funds are required to make considerably more than ten investments a year, allowing for the fact that the 40 companies must have received their financing in at least two tranches. This requirement is one of the key differentiators between the RVCFs and VCs or VCTs.

7.4 The relatively high level of investment activity among angels reflects the fact that they are essentially networks of individuals with differing investment appetites. This is likely to mean they invest across a broader spectrum of opportunities than other investors, who would typically have a more focused strategy. Indeed, they are individually accountable for the performance of their investments, rather than to a set of separate investors. This allows for a more idiosyncratic and opportunistic investment strategy.

Chart 30: Average number of annual investments by fund size



Source: Almeida Capital research

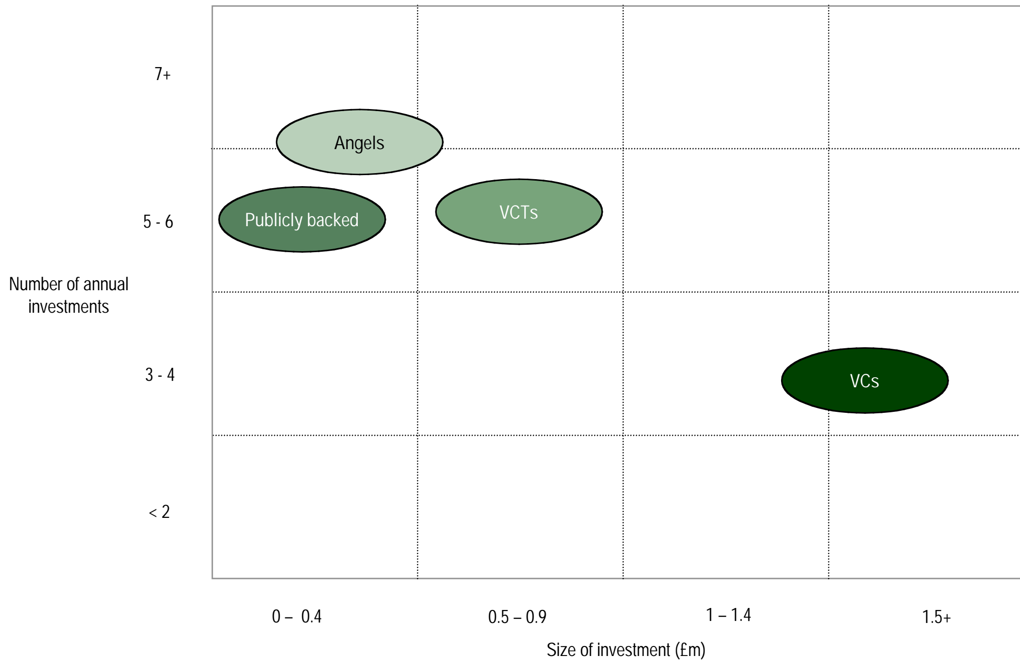
7.5 The same dynamic largely explains the contrast in the breakdown of the average number of investments according to fund size. The larger the fund, the fewer the number of investments they make. The most active category of fund size is that which captures the RVCFs. At the other extreme, funds of greater than £100m make on average less than two investments each year. The difference between these two categories – essentially the RVCFs and the VCs – has possibly been exaggerated during the period in question by the general slowdown in VC activity that followed the implosion of the venture bubble in 2000. As discussed earlier, this post-bubble period has seen a dramatic slowdown by most VCs and a concentration on their strongest portfolio companies. RVCFs have been unaffected by these cyclical developments. Indeed, the migration of many of VCs and VCTs away from smaller and earlier stage deals may in some cases have strengthened the quality and quantity of RVCF deal flow.

7.6 The data suggests, however, that VCs tend to make a near constant number of investments regardless of their fund size. As the funds get larger, they simply make larger investments. By contrast, publicly-backed funds tend to increase the number of investments they make in line with the size of their funds. This is because the size of their investments is inelastic. They are mandated to target a particular equity gap and so they are restricted in the size of investment they can make. The effect is that the larger their fund, the more deals they are required to do.

7.7 The economics of fund management, however, means the publicly-backed funds are unlikely to be able to increase their resource accordingly. This is one of the chief concerns about the investment model adopted by these funds that were expressed by venture professionals during the course of interviews. “Management fees allow you to employ a certain number of people depending on the size of the fund. You can’t get away with altering that management fee just because you want to make a lot more investments. So if you

are going to make a lot of investments you are going to have to do it with the same sort of number of professionals as you would have at a fund making far fewer investments. And that means you are going to have to adopt a completely different approach to due diligence, legal work, and portfolio management."

Chart 31: Market position of fund types by volume and value of investment

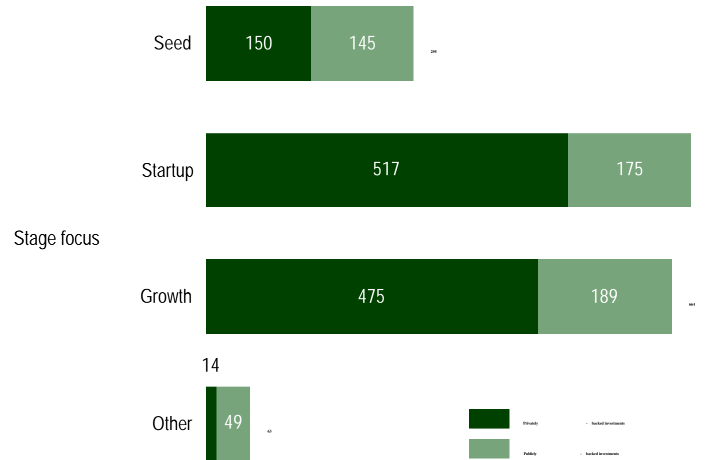


Source: Almeida Capital research

7.8 The extent of the differences in investment behaviour between the various fund types is evident in Chart 31. The matrix positions the types of funds according to the size and volume of their investments. It shows clearly that each of them employs a markedly different strategy on the spectrum of volume and focused investing. It also has implications for the precise location of equity gaps. The greater concentration of the large funds on large investments means there is often a shortage of capital for firms whose funding requirements fall somewhere between the focus of the smaller funds and the next level up. "The larger groups are pretty risk averse. They want a quicker exit than is generally achievable from early stage investing. There are a lot of fairly early stage businesses that are out there now that raised a first £300,000 or £400,000 but have got stuck at the next stage. The big funds have really got to put away much larger amounts and there are only a very small number of deep-pocketed investors who can back a company all the way to profitability," said one early stage VC.

Investments by stage

Chart 32: Number of investments by stage 2003-04, by publicly and privately-backed funds

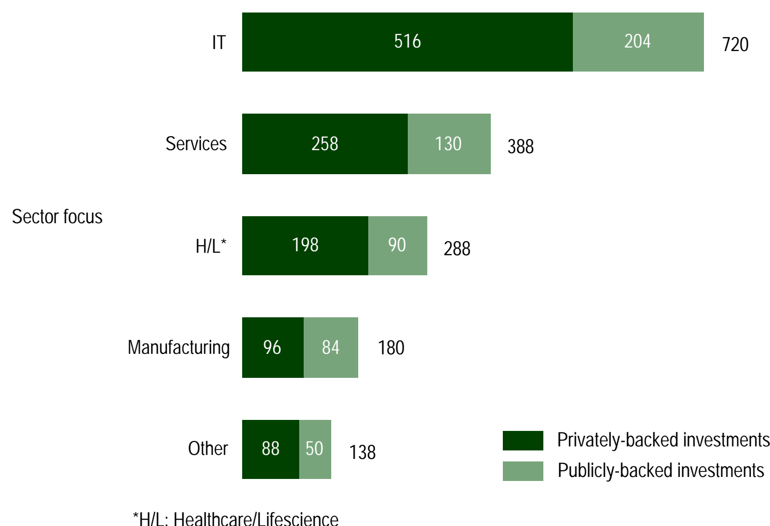


Source: Almeida Capital research

7.9 The largest share of all investment activity during 2003 and 2004 was at the start-up stage, accounting for 40 per cent of all activity. (Stage has been defined by the nature of the investment rather than its size, in line with the method most commonly applied by private equity firms.) Growth investments accounted for 39 per cent of total activity and seed deals for 17 per cent. Publicly-backed funds accounted for 28 per cent of growth investments, 25 per cent of start-up investments and 49 per cent of seed deals. These figures demonstrate the importance of the publicly-backed funds at the earliest stages.

Investments by sector

Chart 33: Number of investments by sector 2003-04, by publicly and privately-backed funds



Source: Almeida Capital research

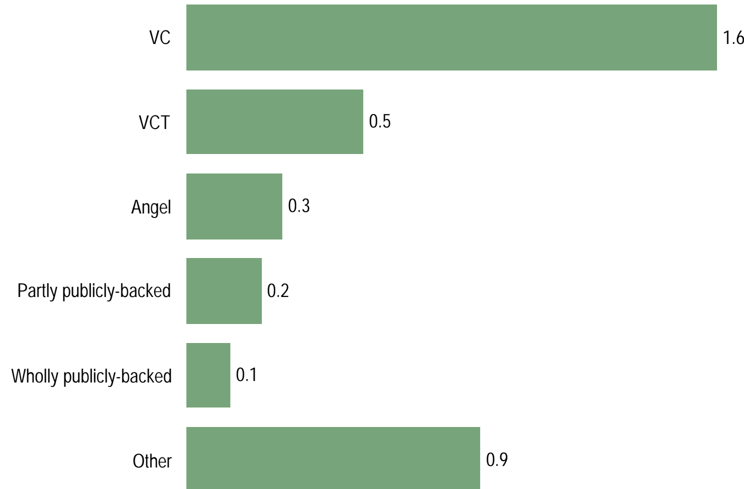
7.10 Investments in information technology (IT) accounted for the largest share of all investments in 2003 and 2004, some 42 per cent. The services sector accounted for a further 23 per cent, followed by healthcare and life sciences with 17 per cent and manufacturing with 11 per cent. The popularity of technology investing reflects the demand for equity financing from firms that often lack the assets to secure any other form of finance and long development (pre-revenue) stages as well as a desire for venture investors to back high growth businesses.

7.11 Publicly-backed funds made up 28 per cent of all the IT investments, 34 per cent of the services investments, 31 per cent of healthcare and life sciences investments, and 47 per cent of manufacturing investments. This pattern suggests they have a greater appetite or inclination towards investments that require less specialist expertise. There are, however, significant differences between the various types of publicly-backed funds. The UCSFs and some Early Growth Funds, for example, make more specialist investments, as befits their mandate, while the RVCFs generally make relatively few.

Size of Investments

Investment size by type of fund

Chart 34: Average investment size by type of fund (£m)



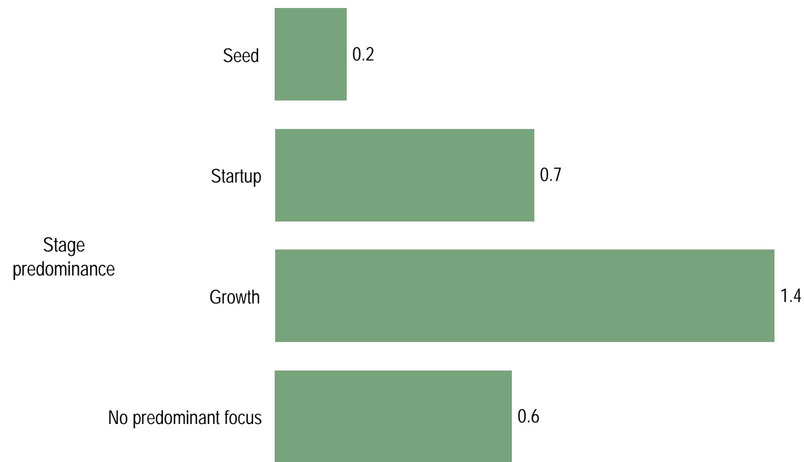
Source: Almeida Capital research

7.12 The average investment by VCs is £1.6m, around three times larger than the next type of fund. This reflects the fact that VCs are investing out of much larger funds. They are also generally investing in more capital intensive sectors, such as technology or life sciences, or in companies in a later stage of development and thus requiring more capital. This figure understates the average size of deal that is undertaken by VCs because the survey shows that a significant proportion of their investing is done in syndication with other VCs. The total equity package can reach in excess of £20m. "Classical VCs all say they do small deals and that they will invest as little as £1m but the reality these days is that they are investing that £1m as part of a syndicate so it is, in fact, a much larger investment. There are economies of scale investing in larger deals as well as being less risk. It costs the same to do due diligence of a £25m deal as on a £250k deal," said one VC.

7.13 The other types of funds are usually restricted in the size of investment they can make, although syndication often enables them to participate in much larger financing rounds than their limit would suggest. VCTs, for example, are limited to investing up to £1m in a company in a single year. RVCFs can only invest £250,000 in a single investment and a maximum of £500,000 per company. Angels are the only source of capital that is not restricted, although many angels are investing through the Enterprise Investment Scheme (EIS), which has some restrictions on activity.

Investment size by stage predominance

Chart 35: Average investment size by stage predominance (£m)

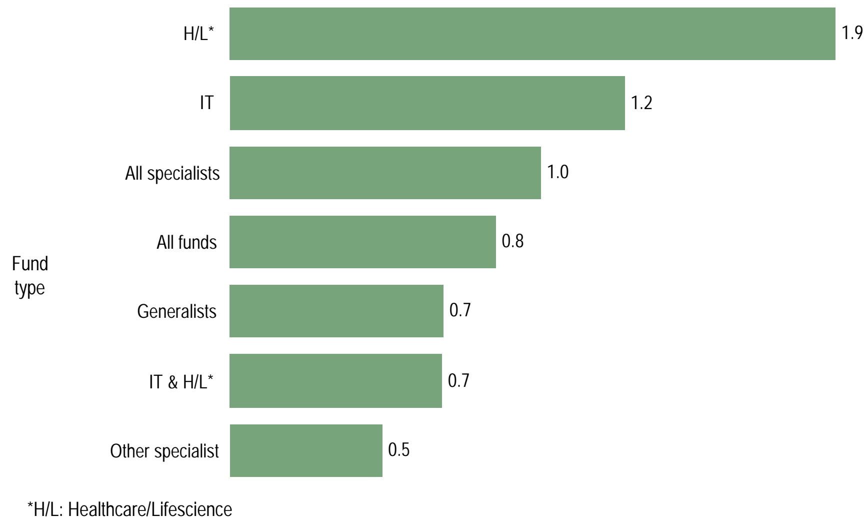


Source: Almeida Capital research

7.14 The average investment size for funds with a predominant focus on growth financings is roughly double the size for start-up focused funds. Self-evidently, firms looking for expansion financing are more mature than start-ups and thus require more capital. For the same reason, the average investment size for funds focusing on seed deals is significantly smaller than start-up focused funds. These figures are not calculated from the size of actual investments but from the average investment size of funds with a given stage focus. The two can, however, be expected to be close to one another.

Investment size by specialisation

Chart 36: Average investment size of generalist and specialist funds (£m)



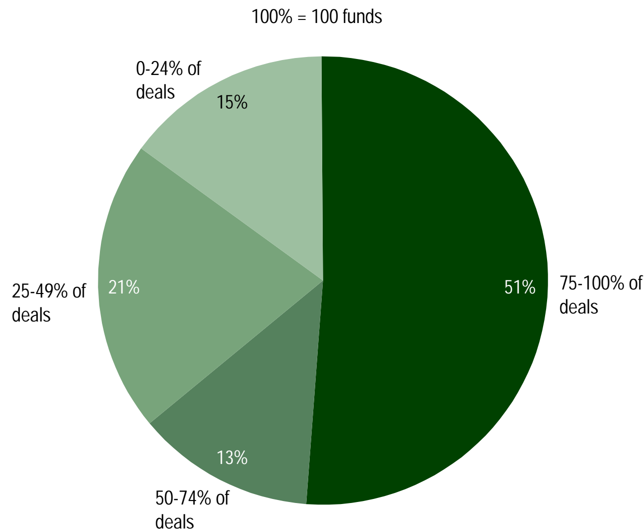
7.15 Specialist investments are on average larger than generalist deals; £1m versus £700,000. This explains the similar contrast in the size of funds managed by specialists and generalists. Technology and life sciences businesses require substantial quantities of capital to grow from the seed stage to becoming profitable. The average investment size for funds with a life sciences specialisation is £1.9m and with a technology specialisation £1.2m, roughly double the average investment size of a generalist.

Co-investment

7.16 One of the most common ways of mitigating the risks involved in providing equity finance to SMEs is to syndicate with other investors. "We tend to co-invest on most of our deals because we don't like finding ourselves alone at the table. It takes a lot of money to support a company from early stage to profitability," said one VC manager. Co-investment enables funds and angel networks to invest in larger deals and to diversify their portfolio of investments more effectively. Although the extent to which funds co-invest is always relatively high, it often varies throughout the financial cycle depending on their appetite for risk at any given moment. So the later stages of the venture bubble, when the appetite was almost insatiable, saw a lot more sole investing than the last few years. Indeed, the last few years have seen a significant increase in the size of consortia, not least because of the desire among VCs and other investors to do larger and thus less risky deals. There are, however, significant differences in the extent and in the nature of co-investment among the different fund types, which need to be explored to understand better their activities.

The extent of co-investing

Chart 37: Incidence of co-investment activity

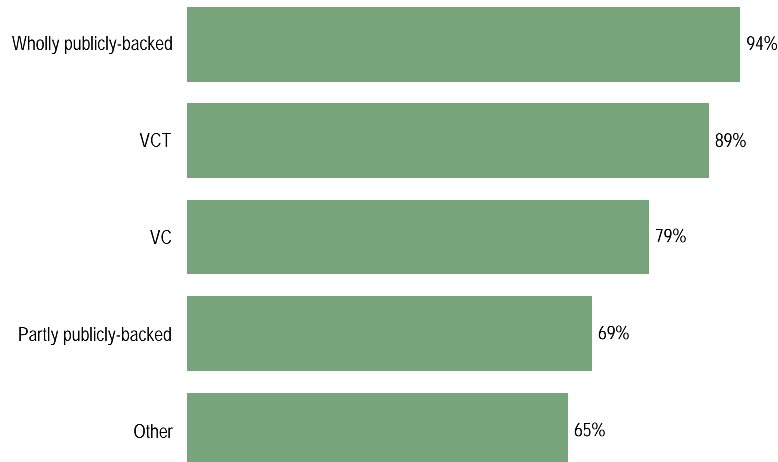


Source: Almeida Capital research

7.17 Co-investment is the norm for most funds. Chart 37 shows that two thirds of them co-invest on more than half of their investments and more than half co-invest on more than 75 per cent. In other words, only about a third do more sole than syndicated investing.

Co-investment by type of fund

Chart 38: Incidence of co-investment activity by fund type



Source: Almeida Capital research

7.18 Partly publicly-backed funds do less co-investing than other types of funds. Some 69 per cent of their investments are co-investments, compared with 79 per cent of VCs and 89 per cent of VCTs. (It is worth bearing in mind that the high figure for VCTs is inflated by the propensity of some fund managers who preside over a series of funds to invest in parallel.) The wholly publicly-backed funds are

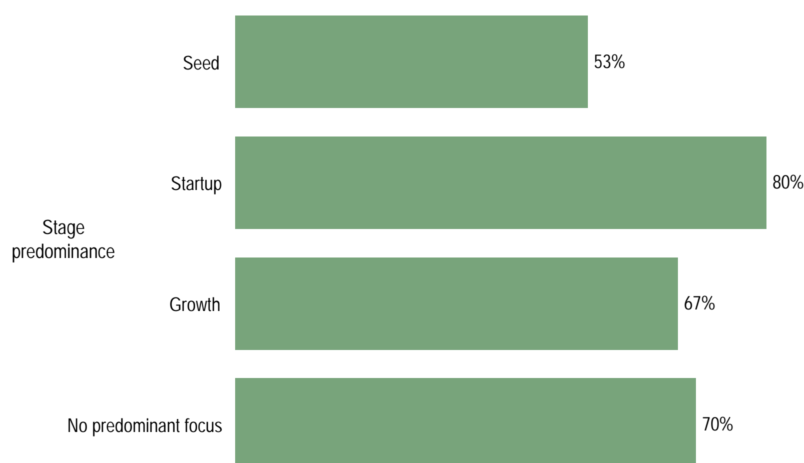
usually required to co-invest, hence their very low level of sole investing.

7.19 Not only are there significant differences in the propensity of sole investing, but there are also major differences in the way the different types of funds co-invest. The RVCFs, for example, who are the most active of the partly publicly-backed funds, usually co-invest with angel groups rather than VCs or VCTs. This is mainly a function of the size and types of deals they do and means they are generally partnering with just one other group. UCSFs are also much more likely to invest with angels than with VCs because of the size of their deals. "We haven't co-invested with any VCs. It has generally been with large private investors. Classical VCs are not really interested in the sort of financing our companies need," said one UCSF manager.

7.20 VCs, in contrast, almost always co-invest with a number of other VCs. Consortia often include as many as five groups. VCTs tend to co-invest either with other VCTs or with VCs. Indeed, in recent years there has been an increased tendency for them to invest alongside one another so as to be able to overcome the limit on the size of their investments. The data about co-investment, alongside anecdotal information provided by a large number of fund managers, suggests the investment activity of the various fund types is often even more divergent than the data initially suggests. Most significantly, it implies that VCs and VCTs are participating in fewer but larger deals than the aggregate activity and investment size numbers indicate.

Co-investment by stage focus

Chart 39: Incidence of co-investment activity by stage predominance



Source: Almeida Capital research

7.21 The highest incidence of sole investing is among seed-focused funds, which co-invest on just over half of their deals. This reflects the relatively small amount of capital required to make a seed investment and also the fact that there are only a small number of active seed-focused investors. The lowest incidence of sole investing

is among start-up investors. The combination of technology risk and the demand for capital at the start-up stage explains the high proportion of co-investment. Growth investing, in contrast, typically presents a lower technology or indeed operational risk profile even if the size of the investment is generally larger.

Public and private overlap

7.22 The differences in investment behaviour between the publicly-backed funds and the privately-backed funds suggest little overlap between their activities. Although active in similar sectors and at similar stages, the size of their investments is markedly different, particularly once co-investment activity has been taken into account. Generally, the publicly-backed funds, whether investing at start-up or growth stage, are making smaller investments in smaller businesses. They also have a greater propensity to invest in non-technology businesses. And, perhaps most importantly, they have a far greater appetite than privately-backed funds for seed investments.

7.23 The idea that publicly-backed funds played a complementary rather than competitive role in the market was strongly endorsed during interviews with managers during the course of the survey. There was a commonly held view that the RVCFs, for example, while related to conventional venture capital funds to the extent that they made equity investments, were essentially focusing on a different part of the market. There was also sufficient demand for finance that the presence of publicly-backed funds did little to distort the market. "There is such a big funding gap at the early stage that everyone is welcome. What we offer (as a VC) is completely different from what the publicly-backed funds offer. We are technologists interested in globalising a business. They are really local groups with local contacts trying to get local businesses off the ground," said one VC.

Summary

7.24 The publicly-backed funds accounted for nearly a third of all investments during 2003 and 2004, making them an extremely important source of capital to the SME sector. The figure also understates the relatively larger number of individual companies they have backed than other fund types because of differences in the way they co-invest. In contrast with VCs, whose investment size tends to increase in line with the size of their fund, RVCFs just make more investments depending on their supply of capital. This is because, unlike VCs, their investment size is inelastic and defined to target a particular equity size gap. Similarly, the VCs do much larger investments, as befits the size of their funds and their strategies. But their average deal size understates the size of the underlying transaction they are participating in because of the differences in the way they co-invest.

7.25 Despite the significance of the publicly-backed funds, there appears to be little in the way of a disruptive overlap between their activities and those of the privately-backed funds. The RVCFs are judged to play a complementary rather than competitive role in the provision of venture finance, while the UCSFs are among only a very small pool of dedicated seed investors faced with substantial demand.

8

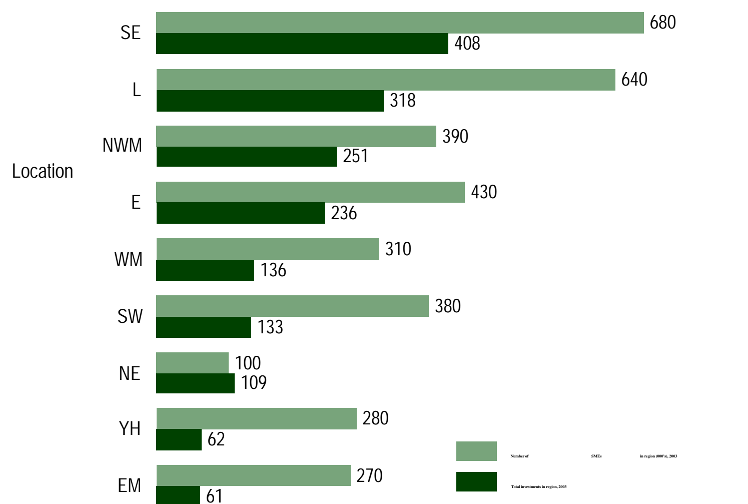
Regional Investment Activity

8.1 There are big differences in activity in the various regions in terms of the volume, stages, and sector of investment. Some of this reflects the nature of their local economies. Some of it is a function of the demand for capital. But a large part appears to result from the supply of capital. Indeed, given the size and importance of the role now played by publicly-backed funds in the provision of venture finance, accounting for nearly one third of all investments in 2003 and 2004, it is only to be expected that supply will be a critical determinant of activity. Some regions have several dedicated funds and the result has inevitably been proportionately higher levels of investment.

Investments by region

Number of investments by region

Chart 40: Total investments and SMEs per region



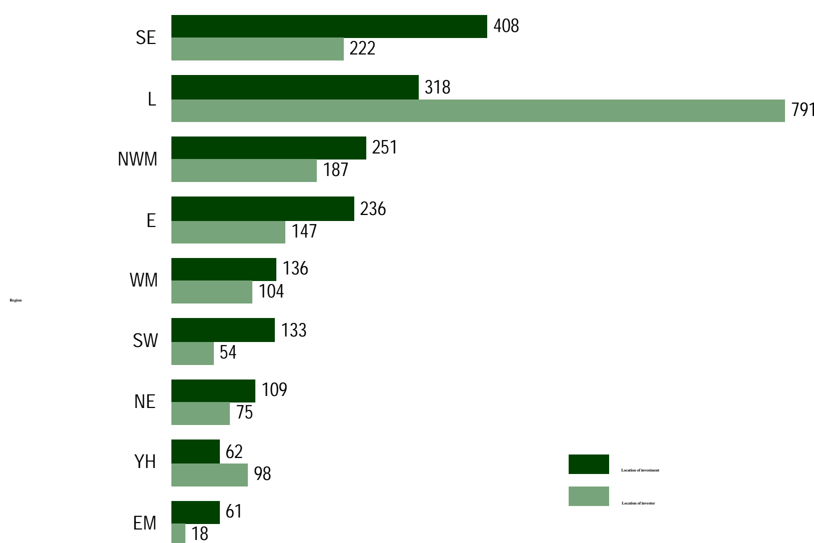
Source: Almeida Capital research, SBS

8.2 The number of investments in the different regions ranges from just 61 in the East Midlands to 408 in the South East. London recorded 318 investments. It falls beyond the scope of this study to analyse the demand for capital in the various regions but it seems reasonable to assume a relationship with the size of their economy. To that end, chart 40 plots both the number of investments and the

number of SMEs in each region to try to identify the extent to which they are correlated. There appears to be some relationship, in as much as the four regions with the highest population of SMEs are also the four regions that have experienced the highest number of investments. However, on this measure, the South West, Yorkshire & Humberside and the East Midlands appear to have proportionately lower levels of investment, while the North East appears to have proportionately higher.

Regional investment by location of investor

Chart 41: Total investment by location of investment and investor*



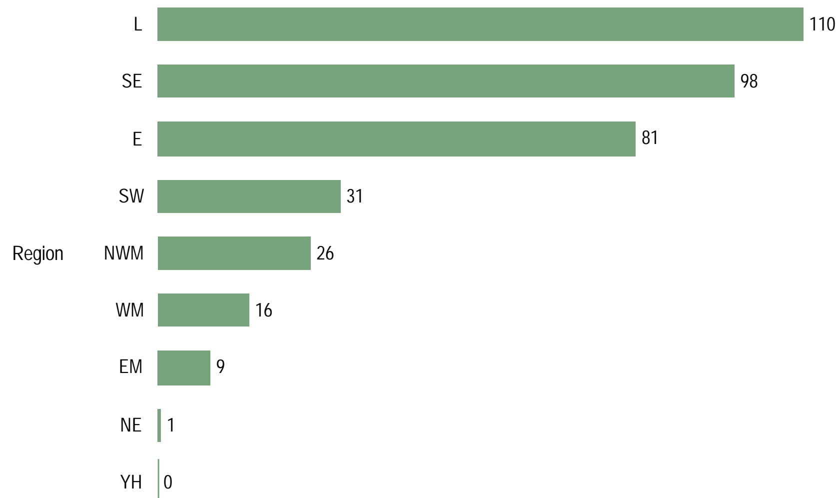
*18 investments were made by companies based in Scotland

Source: Almeida Capital research

8.3 It is impossible to isolate the supply of capital as a factor in the level of investment activity in each region. Investors may be based in one part of the country but invest at the other extreme. The most obvious example of that is the predominance of London-based funds and the extent to which they export their capital to other parts of the country. Almost 80 per cent of London-based groups made investments outside the region in 2003-2004. The number of investments made by the London-based funds was two and a half times the number of investments made in the region itself. Almost all the other regions have been beneficiaries of this phenomenon. Besides London, only Yorkshire and Humberside recorded fewer investments in its locality than the number of investments made by local funds. (This may be explained by the presence of a major venture firm in the region, which invests across the country through a variety of different funds.)

8.4 The location of a fund is usually either determined by its source of deal flow or its source of capital; where it is going to invest or where it gets its money. Given London's pre-eminence in England as a source of capital, it is generally the case that most funds elsewhere are mainly focused on investing locally.

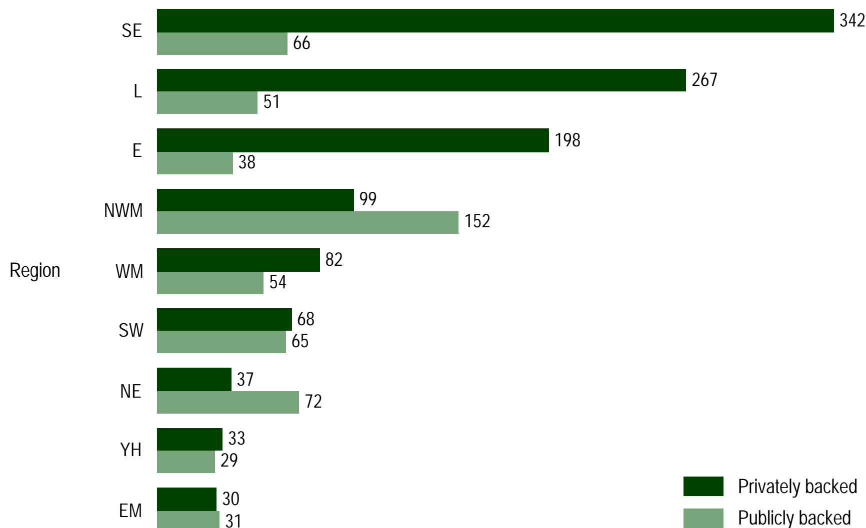
Chart 42: Investments made by non-regionally focused funds



Source: Almeida Capital research

8.5 Chart 42 shows the number of investments in each region that were made by funds that did not have a particular focus on the region in question – funds, in other words, that were not required by their mandate to invest in that part of the country. It shows that the South East, London and the Eastern region all imported a significant number of investments. At the other extreme, the East Midlands, Yorkshire and Humberside and the North East appear to have been the least successful in attracting investments from non-regionally focussed funds. That could be due to the regional funds meeting all the demand. On the other hand, it could mean that those areas have been less attractive to non-regional funds.

Chart 43: Investments made in each region by publicly and privately-backed funds per region, 2003-04



Source: Almeida Capital research

8.6 The importance of the publicly-backed funds has already been established but their impact on local activity varies considerably from one part of the country to another. Most of their supply of capital has been distributed regionally, either through RVCFs, EGFs or UCSFs (which have a de facto regional focus, albeit not one that is always defined by the same boundaries). So it is important to examine the extent to which these funds affect activity in each region. This will inform judgements about the possibility of any crowding out of private sector investment and will go some way to inform the demand side of the equation in each region.

8.7 Chart 43 breaks down the number of investments made in each region into those made by privately-backed funds and those by publicly-backed funds. It shows dramatically different patterns. In London, for example, the number of investments by privately-backed funds is more than five times the number by publicly-backed vehicles. It would be hard to argue, on that basis, that the public funds are crowding out the private or in any way distorting the market. In contrast, investments by publicly-backed funds in the North West and Merseyside are almost double the number by privately- backed funds.

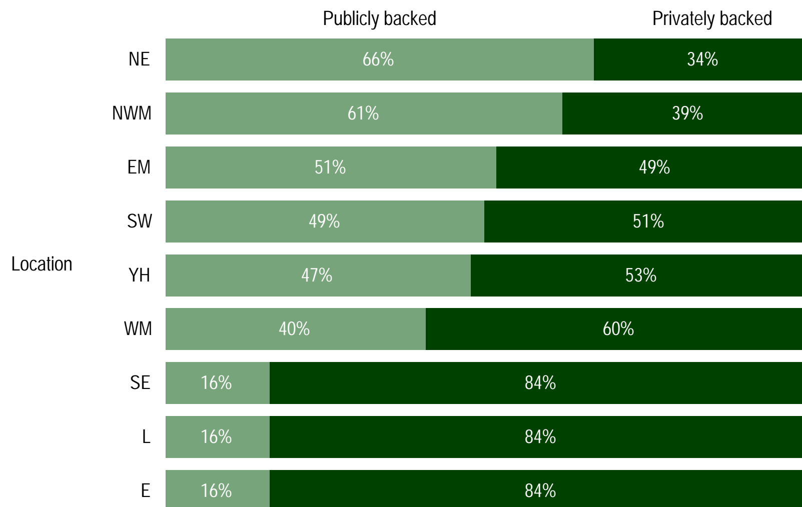
8.8 This might be judged to signal some form of distortion but fund managers of every type in this region, and indeed in every other interviewed in this study firmly rejected that interpretation. “There is absolutely no question of private sector capital being displaced by public sector money. The VCs and the VCTs aren’t doing the small deals,” said one VC manager. In only one region of the country, Yorkshire and Humberside, did a manager complain of being crowded by publicly-backed funds. “The proliferation of different small end VCs that are subsidised by the public sector can be a frustration for us,” he said. Managers suggested instead that a

positive balance of investments made by publicly-backed funds over privately-backed funds signifies investment activity that would not have been undertaken by private investors. In most instances they are smaller or early stage deals in the equity gap being targeted by the different types of publicly-backed funds.

8.9 The data and the response of managers of all types implies, in fact, that the various publicly-backed initiatives are having the desired effect of financing businesses that would otherwise struggle to source private capital. There is, however, still a possibility of an oversupply of capital in some parts of the country, a concern that was expressed by a handful of VC managers. "The supply of small end VC funding is different in different parts of the country but undoubtedly in some parts of the country there is too much supply and not enough deal flow. Some of the funds also have ambitious targets and a lot of them are struggling to get their money out," said one VC. Another manager, active in the North West, echoed that point with particular reference to his locality. "The North West is well furnished with capital. It has a very active RDA. There are a lot of regional funds. If you have a half decent business then you should be able to find some finance. The problem here is the quality of deal flow. It is not finding the money. People who can't raise money bemoan the lack of investors but as an investor it is fair to say there is plenty of money for the supply of opportunity."

8.10 A fund manager with a regional focus on the East Midlands said that he had struggled in recent years to find suitable opportunities, a situation that was further compounded by the strong preference among suitable targets for debt rather than equity finance. "The supply of deals is not great around here. We haven't made an investment in the last two years, although not for want of trying. I just don't think there are that many firms in this area looking for equity investment. I think they see us as a lender of last resort in a way. They'd always rather go to the bank," he said. A genuine oversupply, however, can only be reliably authenticated in the light of the performance of those investments. And it will be some time before the regional funds have a long enough track record to reach that conclusion.

Chart 44: Regional investments by publicly and privately-backed funds



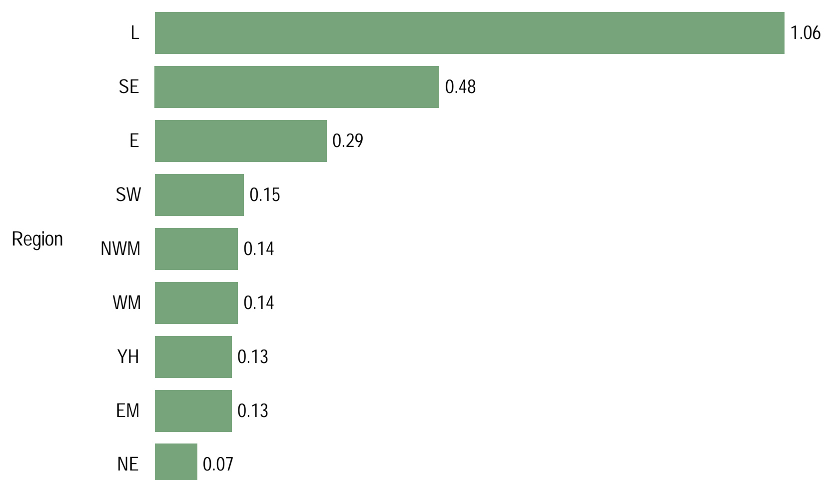
Source: Almeida Capital research

8.11 There are three regions in which publicly-backed activity outnumbers privately backed; the North East, the North West and Merseyside, and the East Midlands. The first of these regions has the highest number of publicly-backed funds.

Investment size by region

Investment size by location of investor

Chart 45: Average investment size by location of investor (£m)

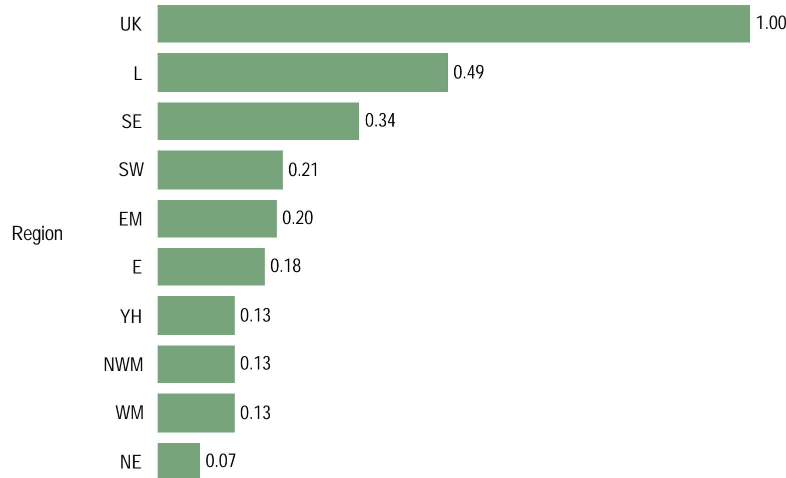


Source: Almeida Capital research

8.12 The average investment made by London-based funds is more than double the next largest and twenty times the smallest.

Investment size by regional focus of fund

Chart 46: Average investment size by regional focus (£m)

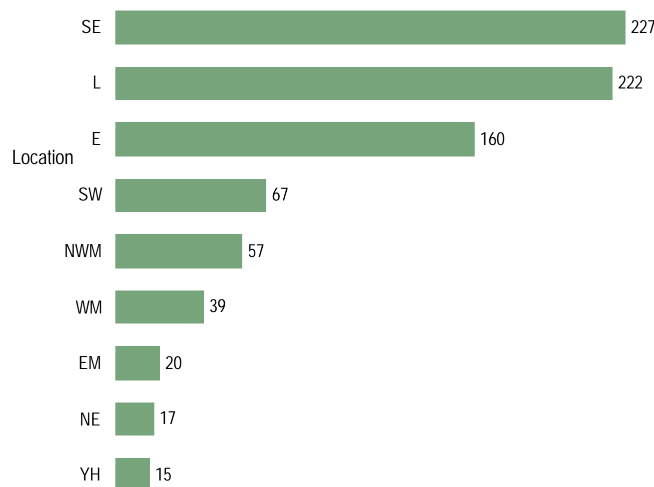


Source: Almeida Capital research

8.13 The average investment size for pan-regional funds, most of which are VCs or VCTs, is more than double that for any fund with a specific regional focus. London-focused funds on average make much bigger investments than funds focused on other regions. One of the differentiators between the regions, given that the RVCFs and UCSFs are all of a similar size, is the local angel networks.

Value of investment in each region

Chart 47: Estimated value of investment for 2003-04 (£m)



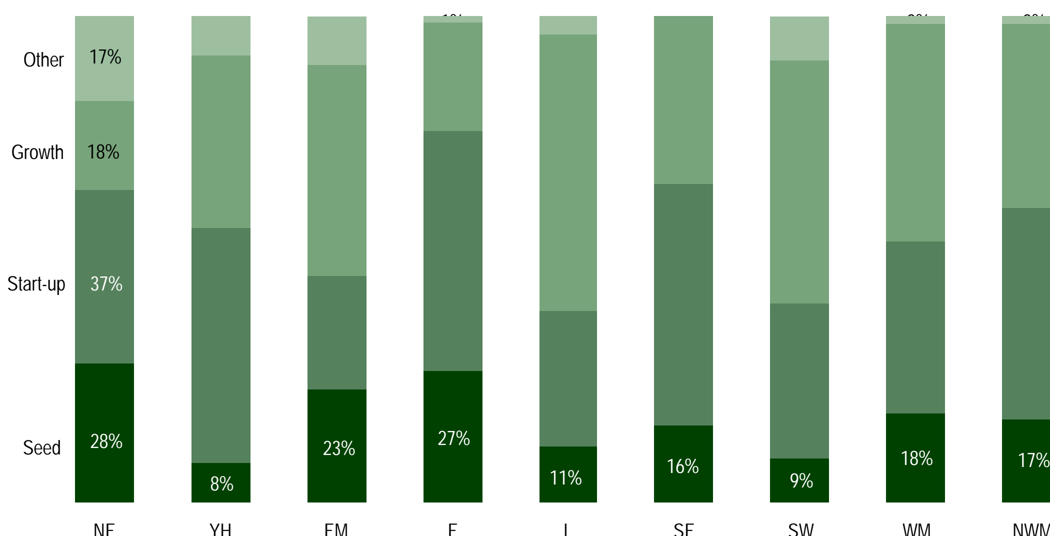
Source: Almeida Capital research

8.14 The South East and London both enjoyed substantially more investment during the study period than any other region. Both were estimated to have attracted in excess of £220m, well ahead of the Eastern region in third position with £160m. All the other

regions received a fraction of these figures. Indeed, London and the South East combined attracted almost 55 per cent of the £824m total invested across England. (The figure was estimated by multiplying the number of investments made by an individual investor in each region by their average investment size and then summing the total for each region. The result should only be considered an estimate of the aggregate value of investment because there is significant variation in the size of investments made by firms in different regions.)

Regional investment activity by stage

Chart 48: Regional investment activity by stage



Source: Almeida Capital research

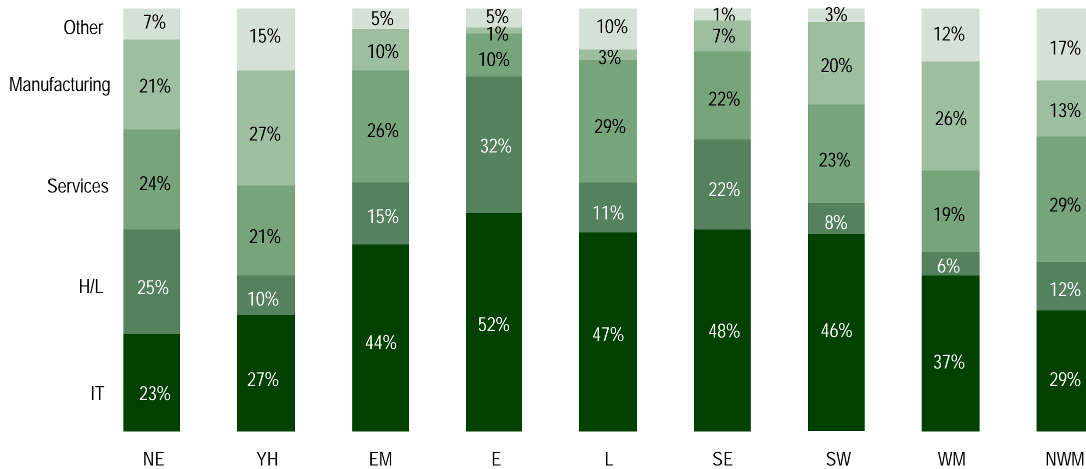
8.15 Most regions have recorded a broad spread of activity by stage although there are significant differences from one to another. For example, there has been very little seed investment in Yorkshire and Humberside, while that earliest stage has accounted for 28 per cent of all the investments in the North East. Start-up investment has been the prevailing stage in five of the nine regions, most conspicuously in the South East and Eastern regions where start-up deals have made up roughly half of all investments. Expansion investments have been the largest share of activity in the East Midlands, London, the South West and the West Midlands.

Regional investment activity by sector

8.16 The composition of sector activity in each region is likely to be largely a function of the local economy. Some parts of the country have more technology businesses than others, underpinned perhaps by local academic institutions and the momentum effects of clustering. Other parts of the country are still more dependent on traditional sectors, such as manufacturing. But once again, the supply of capital and the conditions attached to certain funds can have an offsetting effect.

Breakdown of regional activity by sector

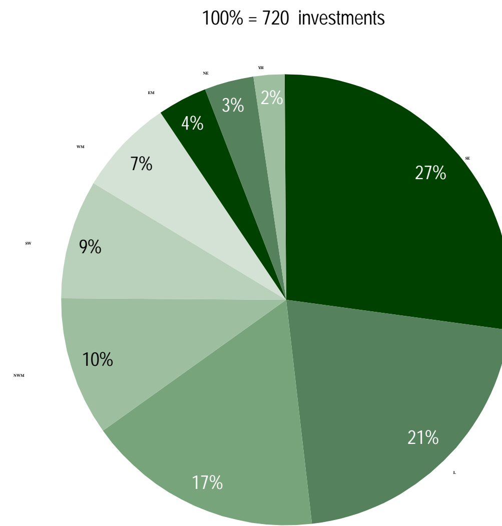
Chart 49: Regional investment activity by sector



Source: Almeida Capital research

8.17 Investing in IT ranges from 23 per cent of all transactions in the North East to more than 50 per cent in the Eastern region. It is the largest sector in six of the nine regions. Healthcare and life science investing is even more broadly spread. It makes up just six per cent in the West Midlands but some 32 per cent in the Eastern region. Services sector investments account for a fairly even share of activity in all the regions of between 19 per cent and 29 per cent, with only the Eastern region falling significantly short of the bottom end of that range. Manufacturing deals are almost negligible in Eastern region, London and the South East but make up as much as 27 per cent in other parts of the country.

Chart 50: Sector breakdown by region: IT

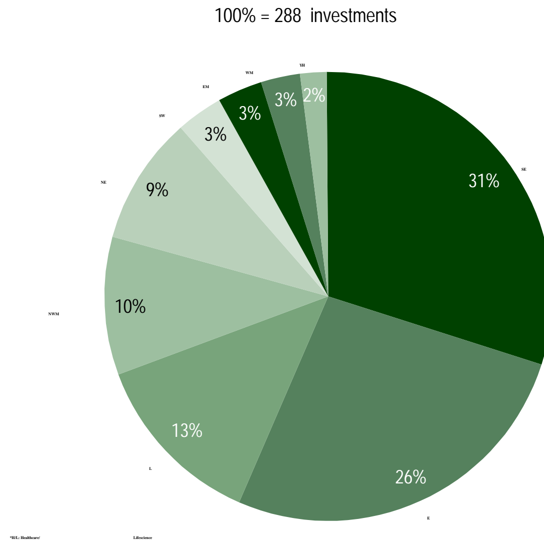


Source: Almeida Capital research

8.18 The South East and London account for almost half of all IT investing by volume in England. Both regions have sizeable and established technology bases around their universities, in particular, and in the Thames Valley. The next largest share is accounted for by the Eastern region. The North East, Yorkshire and Humberside, and the East Midlands together account for less than ten per cent of all IT investing.

Healthcare and Life Sciences investing by region

Chart 51: Sector breakdown by region: H/L*

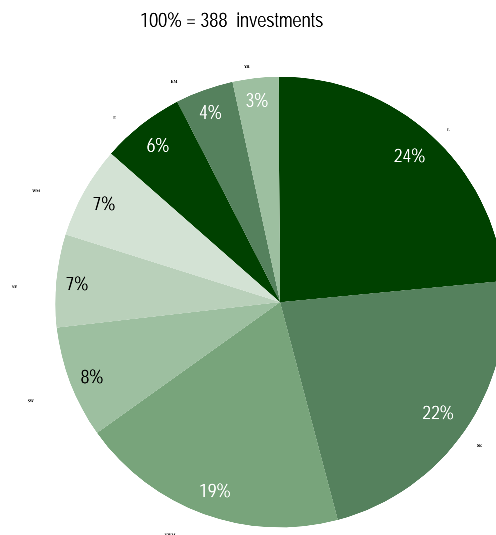


Source: Almeida Capital research

8.19 The South East and the Eastern regions account for over half of all healthcare and life sciences investing. Again, they are established centres of research and development.

Services sector investing by region

Chart 52: Sector breakdown by region: Services

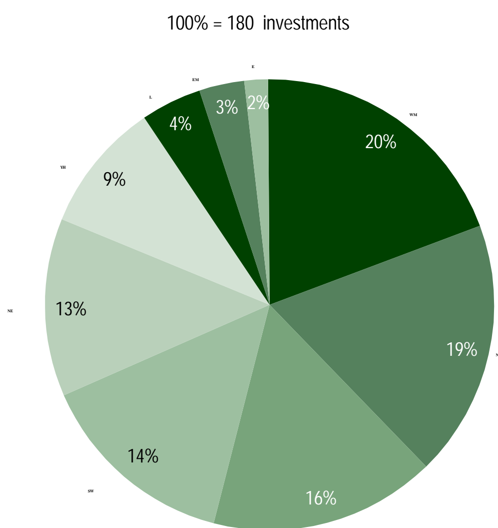


Source: Almeida Capital research

8.20 The breakdown of service sector investments shows a familiar pattern. The South East and London, alongside the North West and Merseyside account for the largest share of investment activity.

Manufacturing investing by region

Chart 53: Sector breakdown by region: Manufacturing



Source: Almeida Capital research

8.21 In contrast to the other sectors, London, the East Midlands and the Eastern region together account for just over ten per cent of all manufacturing investments. The North West and Merseyside, and the West Midlands together claim nearly 40% of all investments in the sector.

Summary

8.22 There is evidence to suggest that there may be imbalances in local supply and demand in different regions. Some regions appear to be attracting a substantial amount of investment from funds without a specific regional focus while others do not. It does not appear, however, as if there is any significant crowding out by public sector investors of the privately-backed funds, a view further reinforced by the comments of VCs and fund managers of all sorts. The relative levels of activity by publicly-backed and privately-backed funds in the various regions might also be interpreted as a measure of imbalance between private sector supply and demand. In London, for example, there are ten times the number of privately-backed investments as publicly-backed. In the North West and Merseyside, in contrast, there are twice as many investments by publicly as privately-backed funds. Given that the different fund types are investing in different parts of the market, the regional activity of publicly-backed funds is best interpreted as deals that would otherwise not have attracted the interest of privately-backed funds.

Appendix 1

Managers of all the various types of funds were invited during the course of the study to air their views about issues that affected their activities. These ranged from frustrations with policy to disenchantment with the quality of their deal flow. Those issues that related to the core of this study, the provision of venture finance to SMEs, are covered in this section.

The relationship between different fund types

The relationship between VCs and other types of investors can sometimes be antagonistic. This generally stems from the singularity of purpose displayed by venture firms; their undiluted focus on generating returns. Obviously all types of funds are motivated by a desire to invest profitably but some also have complementary ambitions. The publicly-backed funds, for example, were conceived with a particular policy objective in mind; to focus on an equity gap in their specific region. Corporate venturing units are investing in businesses or technologies that are of strategic as well as financial interest. And angels are often investing not just with a view to making money but also to indulge their interest in growing small businesses and sharing their expertise and experience.

This antagonism is most commonly expressed by venture firms as a frustration at the lack of professionalism exhibited by other types of investor. "We have come across instances where a business had great technology and we would have liked to invest but they were overladen with dumb money; local funds and angel investors. It becomes impossible to work with a business where that is the case," said one VC.

Other types of investor, for their part, typically characterise VCs as being aggressors. "VC terms are always very onerous. They are ridiculously predatory. They know they are generally the only guys in town. They have seen your cash diminishing and realise they are in a very strong position. At the moment they are really more interested in investing later stage anyway...There was a similar period about ten years ago when they were insisting on multiple liquidation preferences, anything to make sure they got their money back before anyone else," said on UCSF manager.

While this is the most commonplace tension within the wider investor community, there are other frustrations between the different sub-segments and fund types. Privately-backed funds, for example, often expressed some scepticism about the activities of publicly-backed funds, particularly about the fact that their investment decision-making might be compromised by their policy function. "People like us are involved in straight commercial funding of early stage businesses whereas they seem to think there is some grander obligation to the economy to establish these businesses. We don't seem to speak the same language as tech transfer units. They don't seem to understand that our obligation is to generate returns for our investors. The bottom line is that we will do whatever makes money," said one VC. By the same token, some

investors said publicly- backed funds sometimes felt a resistance to interact with privately-backed funds. "There is a reluctance on the part of the publicly-backed organisations to work with the private sector. This is cultural," said an angel investor.

Some of the RVCFs were also criticised by other publicly-backed fund managers for exhibiting too much conservatism in their investment strategy. "We have a bad record of working with our local RVCF. They are really only interested in investing in sweet shops; businesses with revenues and some sort of yield," said one UCSF manager.

There was even some irritation directed at angel networks. Some venture firms felt the nature of their investment, not just capital but a high degree of management involvement, provided them with an insuperable competitive advantage. "Business angels have an unfair advantage because not only are they providing capital but they are also offering and giving very cheaply some management experience and support. There is no way a VC could afford to provide the same package. That means that if you think you need more money at that stage you are not going to get it from VCs," one VC said. Angels expressed a reciprocal irritation. "HNWs don't really like VCs – probably because they aren't stupid. Their main concern relates to dilution. The angels don't like taking the upfront risk and being diluted out of recognition at later rounds," one angel said.

Specific obstacles to investment

Quality of Investees

A number of managers complained that the pool of entrepreneurial and management talent in England was not deep enough. "The single most pressing issue is the quality of entrepreneurs and serial entrepreneurs. We are a long way behind the US, even if we are in a good position when compared with many European companies," said one VC manager.

There was also considerable frustration at the lack of understanding prospective investees often had about the role of private equity. "There is a lack of recognition among SMEs and their owners about the benefits of raising private equity to fund the early growth of their business," said one RVCF manager. And even where there was a degree of understanding about private equity, this often did not extend to an appreciation of the investment process. "There is a requirement for first time entrepreneurs to be better informed about the investment process. Ideally corporate financiers of quality would populate this end of the market and or those that needed the information would attend subsidised courses. These initiatives have both been trailed but we haven't seen significant improvement as a consequence of them," said another RVCF manager.

Investment readiness

A number of angels developed this point with particular reference to the issue of investment readiness. They said they were often presented with business plans that were inadequately developed or conceived, which affected their ability to make investment decisions. "We have substantial deal flow but the quality and standard of business plans and presentations is poor. The provision of a high quality of investment readiness programme is essential to increase the rate of investment,"

said one angel.

Another berated the role played by some parts of the existing infrastructure in supporting entrepreneurs looking for equity finance. “Entrepreneurs go to the networks or business links because they are cheap but the quality of their advice often isn’t very good. They don’t understand the investors properly. The government just doesn’t know how to manage quality control.”

Life sciences

The only sector specialists to express annoyance with the environment in England were life sciences funds, although their grievances were common across Europe. “In my view, you’d never think about setting up a biotech company in Europe unless you had to. If we could we would set up all our companies in Boston. The people, the capital markets, and the animal rights situation are all a lot better,” said one fund manager. Another said the situation had been deteriorating in recent years. “The gap between Europe and the US has widened over the last few years. There is a lot more cash in the US and people are really prepared to throw it as businesses. I think the ability to make money in life science investing is much greater in the US than in Europe. That has been reflected in our business. We have let people go in London and taken on new people in the US.”

Some managers were almost nihilistic in their prognosis for the industry. “Part of the problem is that there haven’t been any real winners in Europe. The management teams aren’t as good. They don’t target their money as well. The valuations may be higher in the US but the capital efficiency is much greater too. They run a business with 20 people where in Europe it would probably have 70. And then it is impossible to get rid of any of them. Europe just hasn’t demonstrated that it can make money in life sciences investing and I struggle to think how it will make any money,” said one.

Equity Gaps

Venture providers identified a series of different equity gaps, defined not just by size but by stage and sector as well. In general, the gap was identified at the post-seed but pre-institutional capital stage, somewhere between £500,000 and £2m, seed and very early stage investors, in particular, complained that it had become very difficult to interest VCs in the smaller end of the market because they had been focusing on less risky, later stage investments. Some managers offered more precise definitions and some said there were variations from one region to another. A small number disputed the existence of a gap at all and said that good prospects would always be able to find capital.

The broadest definition of the gap was offered by an angel investor. “There is a big gap at the £2m level, or the £1m-5m level really. The VCs are not interested in that part of the market any more. Some of them have done the decent thing, like Apax, and admitted as much but most of them are still pretending. It means we see people coming back three times to raise funding instead of going for a bigger lump in a single go.” Another angel acknowledged the financial support being provided by RVCFs but said there was still not enough capital to bridge the gap between seed or very early stage and the first round of VC investment.

"Despite the establishment of a number of publicly-backed venture capital funds aimed at the equity gap there is a still a desperate shortage of competitive venture funds in this smaller end of the market."

Other managers said the cap on the size of RVCF investment meant there was now a gap stretching from around £250,000 to £2m, the point at which VCs became interested. "There are differences from one region to another but in general the RVCF and other publicly-funded vehicles have to stop at £250k, at least for their initial investment, and there is no one else here investing below £2m now that 3i has gone," one VC said. Those regions that did not have a significant population of local privately-backed funds were considered to suffer more acutely from a gap above the level of the RVCF cap. "The equity gap in the North East is about £2m. Having funds with investment caps of £250k does nothing to address this market failure," said a local manager.

Supply of public capital

There was a broad range of views among venture providers about the role of the government in providing capital. Most were indifferent or unconcerned about its impact on the market. A very small number felt it created distortions in small regional pockets. And a handful felt it was unhelpfully financing businesses that were not robust enough to stand on their own.

The extreme view was that the government should not be providing any capital to SMEs through the RVCFs. "What we want is for government is for them to keep their bloody nose out of it. No one should be investing in a start-up because of where it is. You make the investment decision because you have looked at all the possibilities and it represents the best option and not because you have been incentivised somehow to invest in it," said one VC manager.

Others felt public sector capital was having the unhelpful effect of financing too many unsustainable businesses; an inefficient deployment of capital and resource. "The government really has to take a more strategic and long-term view of things here. They need to stop, even penalise, the early stage funds for setting up lots of early stage companies. It is the worst idea I have ever seen. Instead they should be concentrating on the transfer and exploitation of technology. Given the state of the markets, the government needs to understand that there should be more non-commercial money available to take things further. The gap between research funding and where commercial money should come in is too big. You end up with loads of little companies, often poorly managed, with no real chance of turning into a viable business," said a life sciences specialist.

Only one VC complained that publicly-backed funds were crowding out the private sector or distorting the market. "The biggest nuisance are the government schemes that have been bringing marginal capital into the market and crowding out VCs that are strong enough to raise capital from the market directly. The idea that there is a shortage of capital for promising SMEs is a myth," the VC manager said.

Issues affecting the publicly-backed funds

A wide variety of views were expressed about the viability of the various

types of publicly-backed funds. The prevailing view was that it was too early to pass judgement on the success of the different initiatives but some managers felt that the way they had been designed meant they were unlikely to be able to achieve their ultimate objective of self-sustainability.

UCSFs

Some managers said the way the UCSF initiative had been set up allowed a very broad range of approaches. "The different behaviour of the various challenge funds owes a lot to the flexibility with which everyone was allowed to set up their funds. Some took the approach that they should use an external manager. Quester, for example. At the other end of the spectrum, Imperial kept it completely in house. It was really about the way they were as institutions," one UCSF manager said. But the predominant outcome was for the funds to act more in the way of distributing grants than to behave as conventional venture investors. "Most of the challenge funds invested their money on a project basis, almost like a grant. Only a few behaved like VCs, where they thought their money could achieve meaningful milestones and returns," said another UCSF manager.

Regardless of the model employed, a number of managers said the funds were too small to be able to achieve critical mass. "The ultimate objective of these funds is to become genuinely evergreen. But they won't be. It is virtually impossible for a fund of that size to become genuinely evergreen. All of the funds will run out of money soon. Even in the most optimistic IT scenario you are talking about two or three years and two or three rounds of financing before you are likely to be in a position for an IPO or a trade sale," said one manager.

Some observed that the initiative had been damaged by the steep downturn in technology markets since the majority of funds were launched. This had made it much more difficult than originally conceived to realise investments and thus free up capital for further investment. "Where the original model hasn't worked in that it had been expected we would now be seeing some realisations. We have three or four businesses that might achieve an exit this year and if we had a couple of realisations then we would get a lot more money back with which to start investing again. We are beginning to run out of cash so we are now working on a care and maintenance basis," said one manager.

The result of this concern about market conditions was a broad-based concern about the extent to which funds in their present form would be able to become self-sustaining. "There are a number of people I am aware of trying to raise money to invest in this sort of thing. But I think they are all finding it difficult to raise the money. I think that there is a role for these funds but there still needs to be an element of government subsidy or involvement to keep people interested."

RVCFs

Thinking about sustainability of publicly-backed funds is more advanced among the challenge fund managers because they are generally older and so closer to needing to think about their future. But there are some concerns emerging about the future of the RVCFs.

"The RVCFs are not going to get any follow on financing unless the government provides them with a second round. They need a track record and they won't have been around long enough to show one. At the end of the day they will be competing for capital with buy-out funds and funds of funds and other institutional funds. Local authority pension funds are all getting phone calls from other funds these days and they have a fiduciary duty to invest with the firms that will generate them the best returns," said one VC.

"I wonder whether the publicly-backed funds aren't doomed to fail. On the one hand they are supposed to be about fostering entrepreneurship but on the other they are supposed to make money. In some respects these are conflicting objectives. Certainly they pull in different directions," said one RVCF manager.

Perception of the publicly-backed funds

The general view among the venture provider community was that the publicly-backed funds were slightly different creatures to privately-backed funds. This prejudice was rarely as extreme as describing them as suppliers of soft money but there was a gentle scepticism about their ability to combine a commercial with a policy objective. There were also some observations about the variations in quality between publicly-backed managers and the extent to which they were attempting to assimilate in the broader venture community.

The extreme view about publicly-backed funds was expressed by a corporate venturer. "The RVCFs tend to be viewed as funders of last resort," he said. And it was a sentiment that some of the RVCFs themselves said accurately reflected the way they had sometimes been received in the market. "There is a large chunk of the market that thinks about us as being quasi-public. At least in the early stages a fair number of potential investees thought of us as being a soft touch," said one RVCF manager.

The variation in the quality among the managers of publicly-backed funds was also a common observation. "The problem we have with challenge funds is that the quality of the management team varies markedly from one to the next. They are not always very good at selecting the best opportunities and they generally don't add much value. I'm not worried about them distorting the market but they are not doing themselves of UK PLC any favours by picking weaker companies," said one VC. Another said, "There is a really big difference in the quality of the publicly-backed funds. You take someone like Quester, for example, which manages some of the Challenge funds. It is a high quality player and highly professional. But there are real differences at the other end. It often comes down to the people they have managed to attract to the fund. You have got to get the right quality of people and pay them the right way or you are basically adopting a machine gun approach."

Some VCs were more positive about the publicly-backed funds but complained that they had sometimes found it difficult to develop relationships with the managers. "We try to meet the publicly-backed funds. You always hope they might be able to put interesting deal flow your way because they have typically been investing at an earlier stage. The companies have already been through their filter and had some institutional capital. But I don't think they are doing enough to be

proactive about interacting with private sector funds. They should be in our faces and I just don't see them. I don't think they are meeting their responsibilities to network among the private sector VCs," said one manager.

Appendix 2 – Regional Analysis

The following section provides more detailed information about activity in the individual regions. The regional supply is finance relates solely to the funds with an explicit regional focus and makes no estimate of the supply of capital managed by pan-regional groups that might be channelled into the local market.

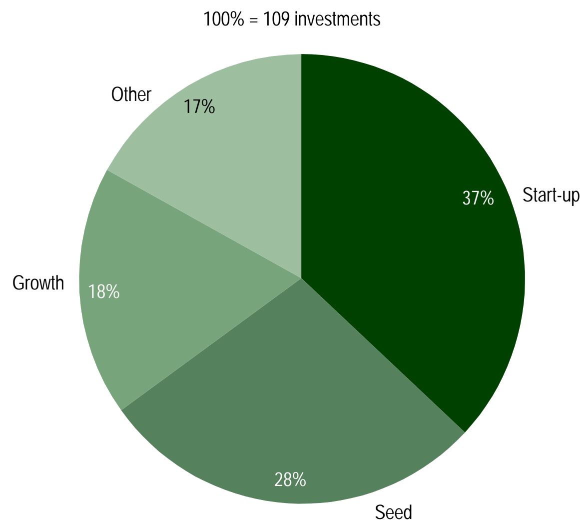
North East

Regional supply of finance (£m)	Average investment size (£m)
66.5	0.07

Fund type	Number
Angel	1
VCT	3
Wholly publicly-backed	3
Partly publicly-backed	3
Other	1
TOTAL	11

Investment type	Number
Seed	31
Start-up	39
Growth	20
Other	19
Public	72
Private	37
TOTAL	109

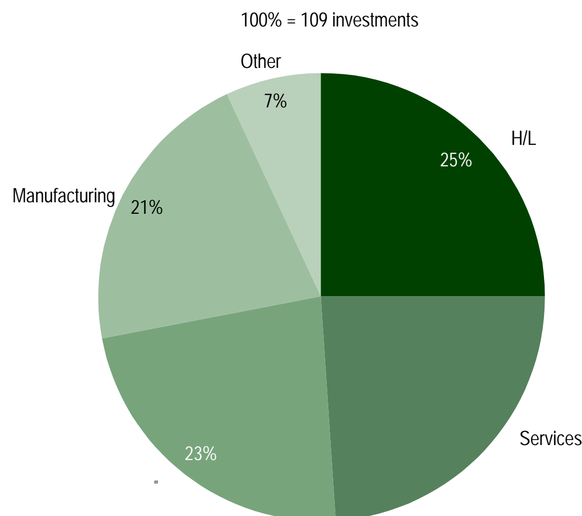
Chart 54: Breakdown by stage: NE



Source: Almeida Capital

The largest stage of investment in the North East is at start-up stage but seed deals also make up more than a quarter of all investments. This reflects the composition of the local fund population. The relatively high proportion of investments described as being 'other' results from the inability of a single respondent to categorise their investments according to any of the conventional stages.

Chart 55: Breakdown by sector: NE



Source: Almeida Capital

Life science and IT investments make up nearly a half of all the investments in the North East, once again a function of the local fund population. The region also has a relatively high degree of manufacturing investment.

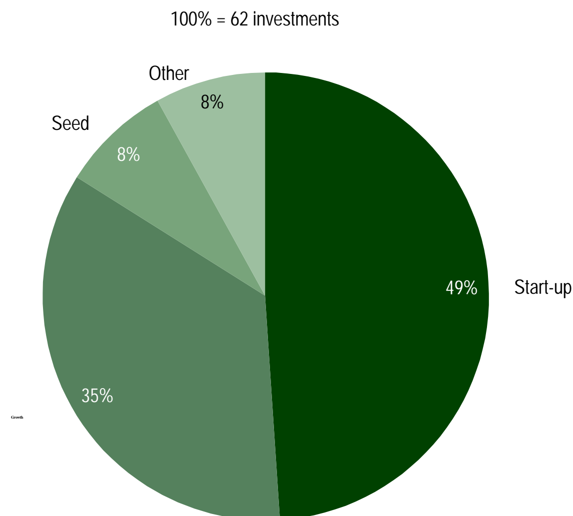
Yorkshire and Humberside

Regional supply of finance (£m)	Average investment size (£m)
116.5	0.13

Fund type	Number
Angel	1
VCT	3
Wholly publicly-backed	2
Partly publicly-backed	3
Other	1
TOTAL	10

Investment type	Number
Seed	5
Start-up	30
Growth	22
Other	5
Public	29
Private	33
TOTAL	62

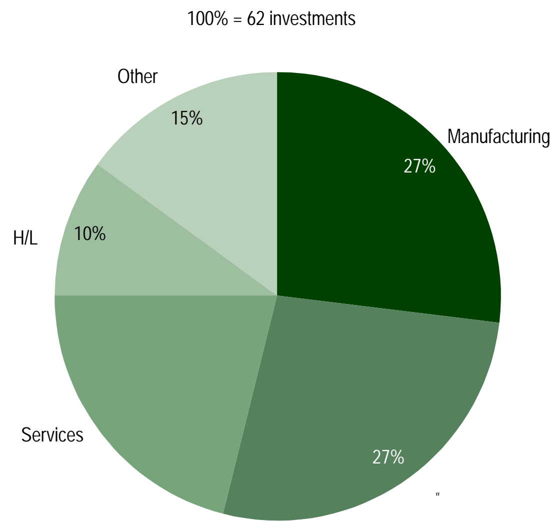
Chart 56: Breakdown by stage: YH



Source: Almeida Capital

Start-up investments account for almost half of all deals in Yorkshire and Humberside. Seed deals, in contrast, make up less than ten per cent. This reflects the fact that there are few seed-focused funds in the region, which is itself a result of the relatively small number of universities and research establishments in the region.

Chart 57: Breakdown by sector: YH



Source: Almeida Capital

Manufacturing is the equal largest sector of investment in the region, corresponding to the composition of the local economy.

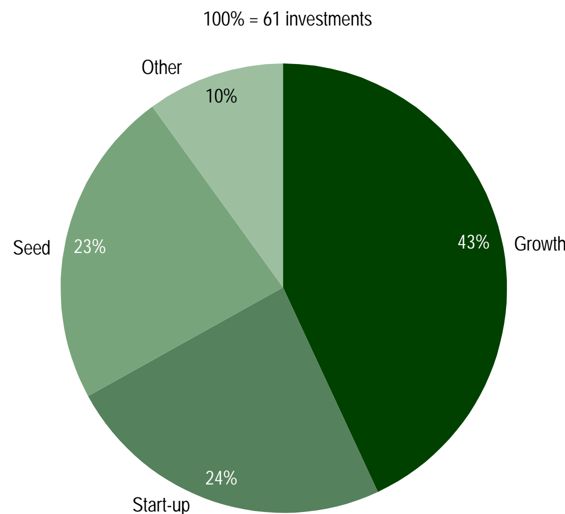
East Midlands

Regional supply of finance (£m)	Average investment size (£m)
92.7	0.2

Fund type	Number
Partly publicly-backed	1
Other	1
TOTAL	2

Investment type	Number
Seed	14
Start-up	15
Growth	26
Other	6
Public	31
Private	30
TOTAL	61

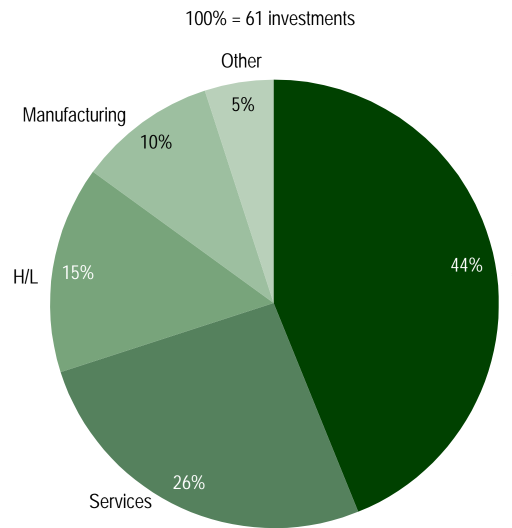
Chart 58: Breakdown by stage: EM



Source: Almeida Capital

Most of the investment activity in the East Midlands is accounted for by publicly-backed funds. The RVCF has focused on growth deals, as befits its mandate, while other publicly-backed vehicles located outside the region (UCSFs) are responsible for the high proportion of seed investments.

Chart 59: Breakdown by sector: EM



Source: Almeida Capital

The relative significance of publicly-backed funds (UCSFs again) explains the high degree of technology investing in the region.

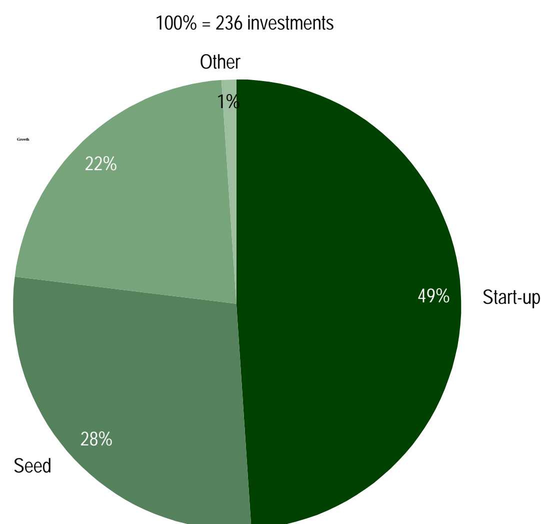
Eastern region

Regional supply of finance (£m)	Average investment size (£m)
114.6	0.18

Fund type	Number
Angel	3
Wholly publicly-backed	2
Partly publicly-backed	4
VC	5
Other	1
TOTAL	15

Investment type	Number
Seed	65
Start-up	116
Growth	52
Other	3
Public	38
Private	198
TOTAL	236

Chart 60: Breakdown by stage: E

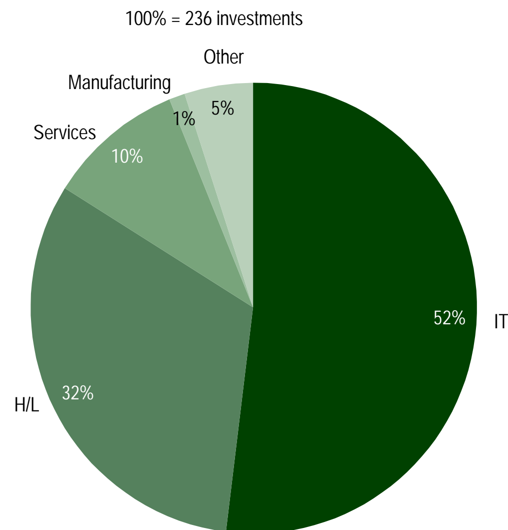


Source: Almeida Capital

Activity in the Eastern region is much more a function of the local economy than the supply of funds. Cambridge and the surrounding area is one of the most significant technology clusters in Europe and has attracted a large number of specialists venture providers, meaning their activity overshadows the activity of the publicly-backed funds. The region's character as a hub of technological research, both IT and life

sciences, is reflected in the very large share accounted for by start-up and seed deals, more than 75 per cent.

Chart 61: Breakdown by sector: E



Source: Almeida Capital

The same driver explains the fact that 84 per cent of all deals in the Eastern region are in the life sciences and IT sectors.

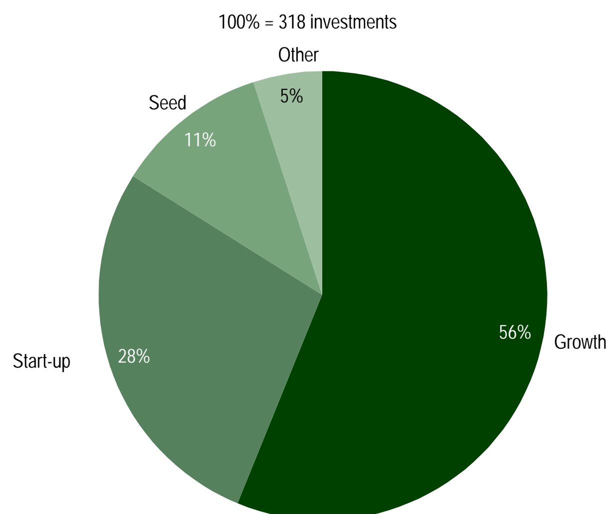
London

Regional supply of finance (£m)	Average investment size (£m)
217	0.49

Fund type	Number
Angel	5
VCT	27
Wholly publicly-backed	3
Partly publicly-backed	10
VC	34
Other	20
TOTAL	99

Investment type	Number
Seed	36
Start-up	88
Growth	179
Other	15
Public	51
Private	267
TOTAL	318

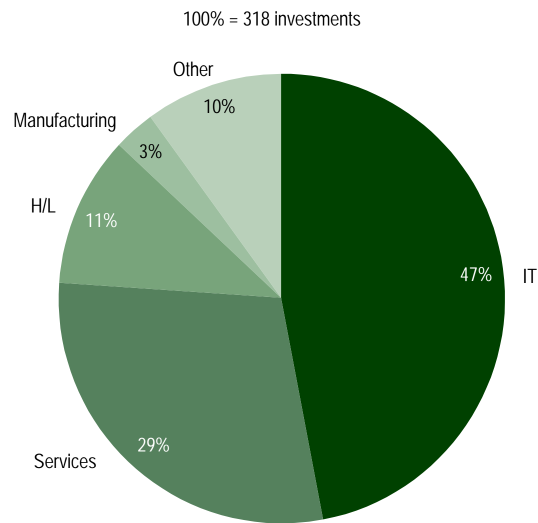
Chart 62: Breakdown by stage: L



Source: Almeida Capital

No other region reports a higher proportion of growth capital investing than London. This may reflect the scale of its economy and the demand for capital from the very large population of small but established businesses.

Chart 63: Breakdown by sector: L



Source: Almeida Capital

The importance of the services sector to the London economy is evident in its share of investment activity. London is also home to a large population of technology businesses.

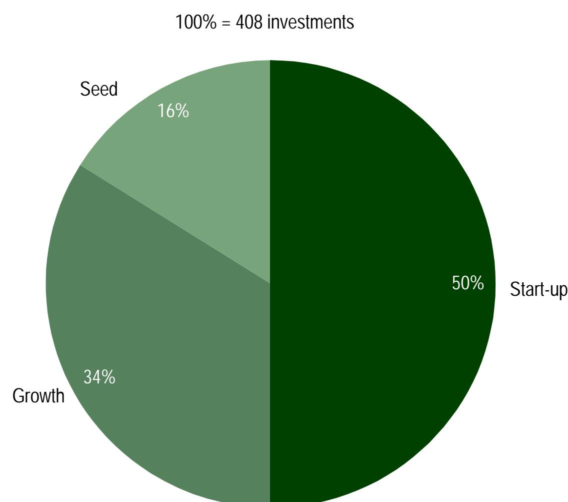
South East

Regional supply of finance (£m)	Average investment size (£m)
211.1	0.34

Fund type	Number
Angel	9
VCT	6
Wholly publicly-backed	1
Partly publicly-backed	2
VC	1
Other	1
TOTAL	20

Investment type	Number
Seed	64
Start-up	204
Growth	140
Other	0
Public	66
Private	342
TOTAL	408

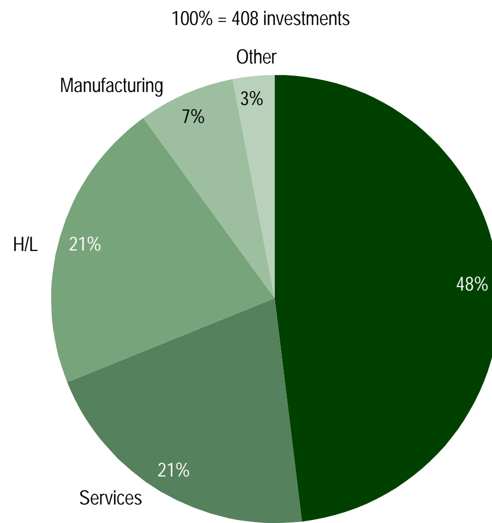
Chart 64: Breakdown by stage: SE



Source: Almeida Capital

The South East, like the Eastern region, has produced a technology cluster of its own across the Thames Valley. This is reflected in the large number of start-up investments in the region.

Chart 65: Breakdown by sector: SE



Source: Almeida Capital

The character of the South East economy is clearly evident in the sector breakdown of its investments. IT is the largest sector, followed by the services sector and life sciences.

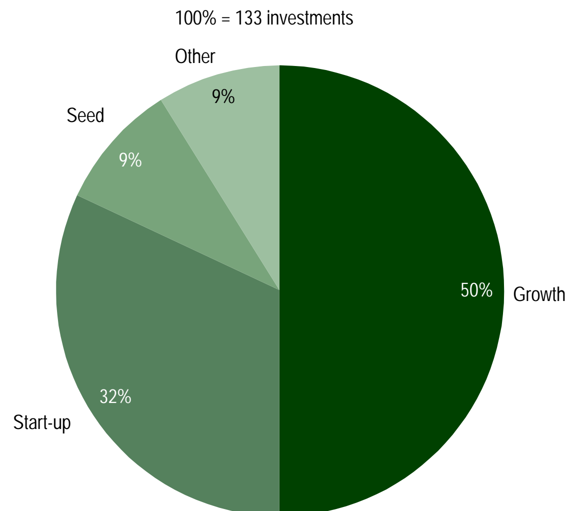
South West

Regional supply of finance (£m)	Average investment size (£m)
66.5	0.21

Fund type	Number
Angel	1
Partly publicly-backed	3
TOTAL	4

Investment type	Number
Seed	12
Start-up	42
Growth	67
Other	12
Public	65
Private	68
TOTAL	133

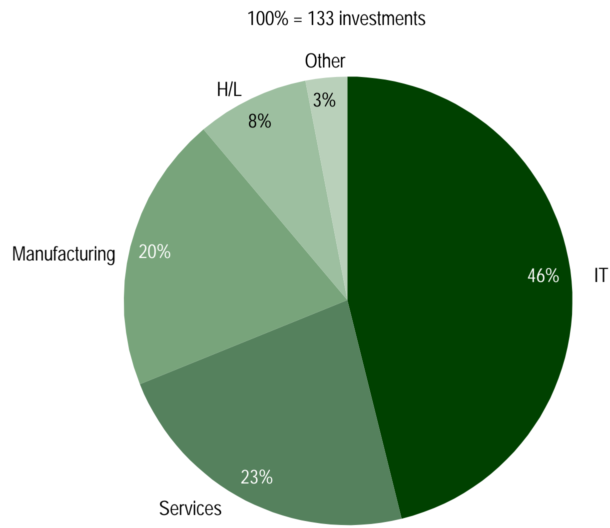
Chart 66: Breakdown by stage: SW



Source: Almeida Capital

Investment activity in the South West, as with several other regions, reflects the composition of the fund population as much as the local economy.

Chart 67: Breakdown by sector: SW



Source: Almeida Capital

The high proportion of IT investing is largely a function of the activity of the publicly-backed funds (mainly UCSFs) in the region.

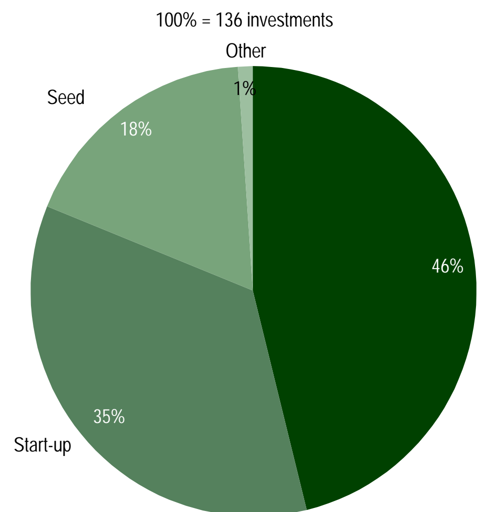
West Midlands

Regional supply of finance (£m)	Average investment size (£m)
50.5	0.13

Fund type	Number
Angel	1
Wholly publicly-backed	1
Partly publicly-backed	4
TOTAL	6

Investment type	Number
Seed	25
Start-up	48
Growth	61
Other	2
Public	54
Private	82
TOTAL	136

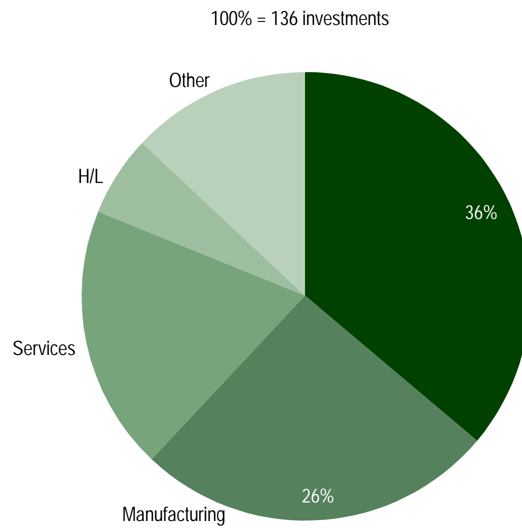
Chart 68: Breakdown by stage: WM



Source: Almeida Capital

As with the South West, almost half of all investments in the West Midlands were growth deals. This is in part the result of the relative significance of its RVCF.

Chart 69: Breakdown by sector: WM



Source: Almeida Capital

Only Yorkshire and Humberside recorded a higher proportion of manufacturing investments. This reflects the nature of the local economies and their supply of investment opportunities. The amount of IT investing appears to be a result of the mandate of the publicly-backed funds in the region.

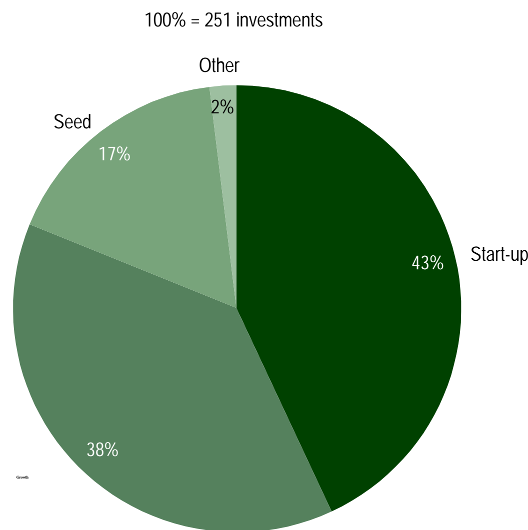
North West and Merseyside

Regional supply of finance (£m)	Average investment size (£m)
139.5	0.13

Fund type	Number
Angel	1
Wholly publicly-backed	4
Partly publicly-backed	4
TOTAL	9

Investment type	Number
Seed	43
Start-up	109
Growth	95
Other	4
Public	152
Private	99
TOTAL	251

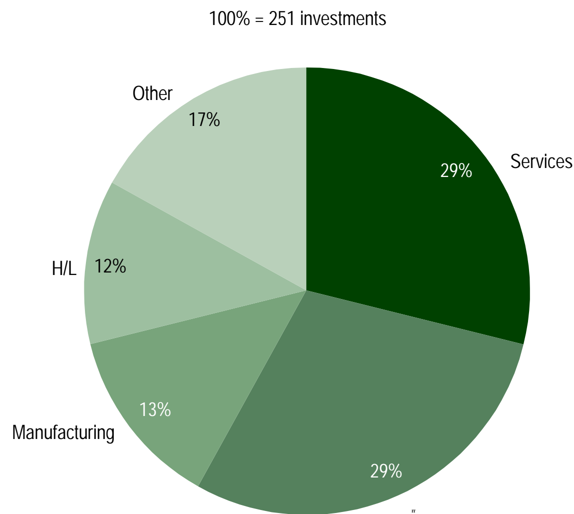
Chart 70: Breakdown by stage: NWM



Source: Almeida Capital

Once again, the breakdown of investment activity in the North West and Merseyside is best understood with reference to the population of publicly-backed funds in the region, which accounted for more than half of all the deals completed during the study period. The region is home to a number of funds with an explicit focus on seed or start-up investing.

Chart 71: Breakdown by sector: NWM



Source: Almeida Capital

Similarly, there are a number of publicly-backed funds in the region mandated to make investments in the technology sector, hence the significance of its share.

List of charts

1	Identification of active investors in SMEs	17
2	Breakdown of active funds by type	18
3	Number of funds by size of fund	19
4	Active funds, by year of establishment	20
5	Location of funds	21
6	Breakdown by regional focus	22
7	Ratio of publicly to privately-backed funds by location	23
8	Breakdown of funds by specialisation	26
9	Fund types: Specialist and Generalist	26
10	Fund types by specialisation	27
11	Location of specialists	28
12	Stage predominance by specialist	29
13	Average size of fund, by fund type	31
14	Average fund size by location	32
15	Annual supply of capital from regionally focused funds	33
16	Average size of fund by stage predominance	34
17	Average size of fund by stage predominance: Publicly and Privately-backed	35
18	Average size of fund: Specialist and Generalist	35
19	Sources of capital, by number of funds in which they are invested	36
20	Breakdown of funds with some public sector capital	37
21	Sources of capital in VC and partly publicly-backed funds	38
22	Proportion of funds with EU funding	39
23	Average size of team (investment professionals) by fund type	41
24	Average size of team (investment professionals) by size of fund	42
25	Average size of team (investment professionals) by stage predominance	43
26	Average size of specialist team by specialisation	43
27	Annual deals per investment professional by fund type	44
28	Total number of investments by fund type, 2003-2004	45
29	Average number of annual investments by fund type	46

30	Average number of annual investments by fund size	47
31	Market position of fund types by volume and value of investment	48
32	Number of investments by stage 2003-04, by publicly and privately-backed funds	49
33	Number of investments by sector 2003-04, by publicly and privately-backed funds	50
34	Average investment size by type of fund	51
35	Average investment size by stage predominance	52
36	Average investment size of generalist and specialist funds	53
37	Incidence of co-investment activity	54
38	Incidence of co-investment activity by fund type	54
39	Incidence of co-investment activity by stage predominance	55
40	Total investments per region, 2003-2004	58
41	Total investment by location of investment and investor	59
42	Investments made by non-regionally focused funds	60
43	Investments by publicly and privately-backed funds per region, 2003-04	61
44	Regional investments by publicly and privately-backed funds	63
45	Average investment size by location of investor	63
46	Average investment size by regional focus	64
47	Estimated value of investment for 2003-04	64
48	Regional investment activity by stage	65
49	Regional investment activity by sector	66
50	Sector breakdown by region: IT	67
51	Sector breakdown by region: H/L	68
52	Sector breakdown by region: Services	68
53	Sector breakdown by region: Manufacturing	69
54	Breakdown by stage: NE	78
55	Breakdown by sector: NE	78
56	Breakdown by stage: YH	79
57	Breakdown by sector: YH	80
58	Breakdown by stage: EM	81
59	Breakdown by sector: EM	82

60	Breakdown by stage: E	83
61	Breakdown by sector: E	84
62	Breakdown by stage: L	85
63	Breakdown by sector: L	86
64	Breakdown by stage: SE	87
65	Breakdown by sector: SE	88
66	Breakdown by stage: SW	89
67	Breakdown by sector: SW	90
68	Breakdown by stage: WM	91
69	Breakdown by sector: WM	92
70	Breakdown by stage: NWM	93
71	Breakdown by sector: NWM	94

Authors: Almeida Capital

This document can be accessed online at: **www.sbs.gov.uk/analytical**

Postal enquiries should be addressed to:
Analytical Unit, Small Business Service, St Mary's House
9-11 London Road, Sheffield, S2 4LA

Email enquiries should be addressed to: research@sbs.gov.uk

The views expressed in this report are the authors and do not necessarily reflect those of the Small Business Service, the Small Business Investment Taskforce or the Government.

The Small Business Investment Taskforce is an independent advisory body appointed by the Secretary of State to advise on access to finance issues for small and medium sized enterprises.

Published in October 2005 by the Small Business Service
on behalf of the Small Business Investment Taskforce.
© Crown Copyright. URN 05/1677