
OPINION

Venture Capital and Science: Mind the Gap...

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As an industry practitioner with a number of years of experience in both venture capital and private equity I welcome the growth and achievement of the venture capital industry in the UK.

Indeed, we should be proud that the UK venture capital industry now accounts for over 50% of the whole European market.

I have more than just professional pride in the industry's success. I am also confident that the central role of venture capital in the UK economy is

helping a very wide range of science based enterprises to flourish.

One VC fund alone, Amadeus Capital Partners, has backed almost 60 technology companies at different stages of business growth and development and in sectors ranging from communications and networking to medical technology.

Nevertheless, many science based enterprises continue to face a challenge in early-stage funding.

In 1998, 10% of venture funding was invested in early stage



companies but that figure had fallen to just 2% by 2005 because of the perception of poor returns on early stage investments.

Some of this underperformance can be attributed to the glut of money made available at the height of the dot-com bubble.

But problems are also caused by the way that the finance cycle has developed over the last few years to make later stage investing look more attractive to venture capital funds.

There are several reasons for this. Early stage investors take the highest risk and must wait longer until any gains can be realised. Early stage enterprises are also smaller and more management intensive for fund managers.

So the challenge facing the science based enterprises is how to attract venture capital fund managers back into the smaller, earlier-stage and riskier end of the market.

And that is also the fundamental challenge facing the Government.

It has responded in several ways but there is still much more that could be done.

First, the Treasury has been engaged in a long running search for the so called 'equity gap'.

This exercise has proved to be much like looking for the Scarlet Pimpernel – it is elusive and tends to be reported in different places.

The gap is said to exist between early stage investors, or 'business angels' who are often enthusiasts, family or friends, and larger scale venture capital funding.

The Government has attempted to respond to the gap by targeting fiscal incentives to attract investment, and it has had some success in doing so.

But the difficulty in providing useful fiscal incentives is that the sheer variety of needs faced by growing enterprises means that incentives are often poorly targeted and can be open to abuse by investors.

This inevitably leads to increasing complexity and tail-chasing.

The answer is not to tinker with the incentives in order to plug a gap, but to look at other methods of assisting science based enterprises more directly.

Second, the Government should continue to look for and support best practice.

The Higher Education Innovation Fund has provided approximately £265 million to help universities establish technology transfer offices and become more commercially oriented.

The European Investment fund has given significant support to the venture capital industry in Europe and enabled firms to raise venture capital funds when they would formerly have been unable to do so.

Likewise, the UK High Technology Fund had a significant impact in supporting early stage investors in the UK but unfortunately there has been no successor to the fund.

These initiatives invest funds with specialist managers and are a very effective way of ensuring that government funds reach professional managers in the target market.

The United States provides a good example of the benefit to the wider economy of further support for early stage venture capital.

The percentage of early stage deals is the same, 34% versus 35%, but the amount of capital is much lower in the UK with approximately 14 times as much money invested in start-ups in the US than in the UK.

US initiatives like the Small Business Innovation Research Programme, which targets government Research and Development funds at small businesses, together with procurement rules designed to benefit early stage companies, would undoubtedly help science based enterprises if they were implemented in the UK.

Third, there is a need to address the specific challenges faced by science based enterprises.

Many are spin-outs from universities, and these are a growing success story. In 2004 the Library House Spin-out monitor identified 435 technology spin outs from the 36

leading research universities in the UK.

Of these, 65% were at the seed funding stage; which in itself underscores the need for more early stage investment.

An excellent example of a university spin-out is Surrey Satellite Technology, now the world's leading manufacturer of small satellites and still 85% owned by the University of Surrey.

Arguably the next logical step would be for the business to seek further venture capital involvement to help it grow – and for the university to reap a healthy return on its investment.

But one of the biggest concerns expressed by the venture capital industry, and by university spin-outs themselves, is the challenge of attracting appropriately qualified management into early-stage ventures.

In fact, a study conducted in 2002 by the Bank of England found that attracting high quality management to spin-out companies was a bigger problem than attracting finance.

So the support that the Venture Capital industry offers to science based enterprises goes deeper than finance; we must also continue to offer the management expertise in order to capitalise on this innovation.

My conclusion is optimistic. The British venture capital industry is thriving and that success will continue to have a very positive impact on science based enterprises.

But the Government can always be smarter about how it spends its money in support of early stage technology companies and how it targets its fiscal incentives.

At the same time venture capital fund managers must remain committed to investing in management expertise as well as finance.