A ccess to appropriate forms of finance is key to ensuring that small- and medium-sized companies have the freedom and the scope to grow. Venture capital – or long-term committed investments in unquoted companies in return for an equity stake – is a potential means of stimulating this growth. For the company receiving the capital it is secure growth finance without the risks inherent in loans secured on property. For the investor it represents a means of generating revenue from the growth of a business.

By stimulating this market the Government would therefore have ample scope for achieving the highly desirable policy objectives of enhancing entrepreneurial activity and generating economic growth. Indeed, politicians and commentators alike point to examples in the US where a buoyant venture capital market appears indeed to have generated a pro-active, pro-risk entrepreneurial culture, which leads to large numbers of business start-ups and high growth through small and medium-sized enterprises (SMEs).

Critical differences exist between regions within the UK, however, which potentially prevent the link between venture capital and growth being quite so clear cut. These differences manifest themselves, first, in terms of macroeconomic indicators such as regional GDP per head and industrial structure and, second, in terms of cultural factors such as the acceptability of venture capital to entrepreneurs as a tool of business growth.

This article looks at the venture capital market as it is developing in the UK, with the aim of informing government policy. It is based on IPPR research, conducted during 1999, which examined venture capital across all regions in the UK. At the time of the research, proposals for venture capital funds in the English regions were out at consultation. Field work research sought to identify both the key issues facing the Regional Development Agencies (RDAs) and local venture capital providers in
these regions, and any factors critical to establishing regional funds successfully.

This largely practice-based research process led to important conclusions, which must inform policy if it is to be truly effective. The principle of venture capital investment rests on investors perceiving a high return relative to risk. In other words, if the growth prospects of the company look outstanding, whatever the company’s core business, it will be appropriate as a recipient of venture capital investment. However, two key factors underpin this statement and, hence, any policy in this sector:

- Return, relative to risk for the investor, is not always clear. Businesses might fail to deliver their full growth potential or fail completely. As a result, many venture capital funds will not invest in companies, since returns are not guaranteed. This is true irrespective of the size of the initial investment. Government policy must take account of this commercial imperative facing the industry’s fund managers by providing risk mitigation through investment guarantees, for example.

- It is by no means clear that formal venture capital (provided through funds) is the most appropriate funding mechanism for all the small businesses that policy aims to support. Entrepreneurs do not always have global, or even national, pretensions for their business, but want simply to provide a living for themselves and jobs for a few employees. For most of these businesses, alternative, largely debt-based finance may be more appropriate. Others may be able to benefit from informal venture capital, for example through business angels, as a means of providing them both with managerial and business expertise as well as with the finance they need. Whichever finance route is taken, however, these businesses are key to the regional regeneration remit of RDAs and their funding needs should not be forgotten in the rush to establish venture capital funds.

The real policy solution lies in close co-operation between all the different agents in the system at a regional and national level. RDAs have the tools at their fingertips to perform the co-ordinating task and, rather than focusing on the funds in their own right, should be concentrating on the issue of harnessing the latent potential that already exists in each region. Many of the problems that currently manifest themselves in the market place originate in imperfections in information. In other words, entrepreneurs know little about how venture capital works and, critically, policymakers and fund holders alike are unaware of exactly how much demand is in the market. All can guess, but no one can be precise. Markets will not function without information and this is abundantly clear for the UK venture capital sector.

The issues

Government’s role is to address the imbalance between the perceived risk of such projects and their potential return. In the most successful models of venture capital there is a substantial degree of government involvement, either through direct subsidy, risk reduction or incentivisation to encourage investment in higher risk projects. There are also clear structures for feeding potential growth companies through the system, from start-up and early stage through to eventual flotation. These structures only become a system through direct involvement by government agencies in ensuring clarity in the operation of the market.

Perhaps most importantly, given the size of the venture capital industry, it remains an under-utilised means of small- to medium-sized enterprise (SME) finance in the UK. British companies have appeared unwilling to use it as a resource, choosing more traditional, debt-based mechanisms (largely through banks) to fund their expansion. Further, British venture capital funds have bemoaned the apparent lack of investment
opportunities in potentially high-growth SMEs. They argue that they have funds available for such investment, but see relatively few good, investor-ready propositions that will provide an adequate return relative to the risk involved. The result is a market that fails to function properly.

The policy

The Government has been quick to spot venture capital potential and launched its support for venture capital funds in 1997. It became explicit policy in the Competitiveness White Paper (DTI, 1998), in which £180 million was committed over three years to a national Enterprise Fund with the following features:

- incorporation of the existing Small Firms Loan Guarantee Scheme (SFGS)
- support for the establishment of regional venture capital funds
- provision of a national venture capital fund supporting early stage and high-tech businesses
- provision of flexible support for innovative business proposals currently not catered for by the finance industry.

In general terms, the aim was to provide funding for the equity gap – in other words, for the smallest companies for start up and early stage growth.

The subsequent consultation document focused specifically on the support for regional venture capital funds under the provision of the Enterprise Fund. The consultation aimed to ‘ensure that support for regional venture capital funds is designed to meet the needs of SMEs in all regions and is compatible with industry practice.’ Within the document, the Government proposed at least nine regionally-based venture capital funds providing ‘equity-based finance to Small and Medium Sized Enterprises (SMEs) in amounts below £500,000’. On the demand side, the objective is to increase availability of this type of finance to SMEs that would otherwise not be able to obtain it. On the supply side, the objectives are to ensure, first, that each region has a viable venture capital fund and, second, to encourage investment into these funds.

De facto these funds would be set up by the RDAs. Accordingly, their establishment features strongly in most RDA economic strategies.

The aim is to address the inherent weaknesses in the UK market through appropriate intervention in the marketplace. Such intervention at a regional level is deemed necessary in order to assist the RDAs in furthering their own objectives of regional regeneration and competitiveness. Achievement of this aim rests on ensuring that regional funds are of a viable size and that regional fund managers have appropriate expertise as well as local knowledge. It is envisaged in government documentation that the intervention will take place in one of three forms: subsidised management costs; co-investment in funds and guarantees for funds (to spread perceived risks on high-risk projects).

Venture capital in the regions

Despite the apparent buoyancy of the market, there are some tangible regional issues that need to be addressed if all potential high-growth companies are to take advantage of this important source of finance:

- venture capital is under-utilised, particularly at levels of finance of less than £250,000 – small companies are reluctant to use equity-based finance for a multitude of reasons, the most common of which are the perceived loss of control attached to this method of financing and the lack of knowledge about what venture capital funding actually is
- demand for equity-based finance is variable across regions in the UK – some regions report relatively strong formal and informal venture capital activity, notably London, the South East, and the East and West Midlands. Further, demand in the East of England is centred around the Cambridge area and has a strong high-tech bias. Sophisticated
networks and structures for venture capital at all levels also exist in Scotland, Northern Ireland and Wales. However, in the northern regions of England, there is little or no demand for venture capital in any form and even the most developed venture capital structures and markets report over-supply of both business angel finance and formal venture capital, relative to demand. Further research is needed to establish the extent of demand for venture capital, since figures are at best unreliable and at worst only estimates of activity.

● there is not a clear relationship between venture capital finance and growth – venture capital finance may well be an important extra tool in sectors with high growth potential. However, companies that do not fit into this exceptional growth category may not be suitable for venture capital financing but are no less important in creating regional employment and growth.

All of these issues give rise to concern about the nature of the industry in general and the operation of the market in particular. There are certainly pockets of venture capital supply around regions in the UK. However, there is little evidence that a market exists, especially in the area of start-ups where information problems dominate. A particular issue across all regions remains the balance between risk and return.

The variability in venture capital activity across the regions is marked. This variability is felt in terms of the presence of existing funds, the relationship between existing funds and RDAs and the integration of venture capital as a growth tool for SMEs into regional economic strategies. Not all RDAs are confident that venture capital is the correct tool for the small businesses that operate in their region. Many argue that mentoring and ‘packaged’ finance (which may in the medium term contain an equity component) would be more appropriate in the equity gap end of the market (arguably less than £250,000). All this leads to substantial differences between regions in the time scale envisaged in setting up a regional fund, in the costs of setting up such a fund and in the format that it would take.

The cases of Scotland, Northern Ireland and Wales demonstrate that the role of the RDAs in relation to regional venture capital funds is perhaps best formulated as a gap filler whose function is twofold: to bridge the inevitable gaps in funds which emanate from the imbalance between risk and return inherent in these types of investment, and to bridge a knowledge gap between investors and investees. This is the product of lack of awareness amongst small businesses of the benefits of venture capital as a funding mechanism, of lack of preparation for investment and of lack of information about investment opportunities.

Policy conclusions

As it is currently formulated, the Enterprise Fund is largely a supply-side response to an essentially demand-side issue. There are clear imperfections in current market operation, both in terms of demand for venture capital at sums of less than £750,000 and in the upward spiral of average investments visible in all funds, even those established with an equity gap remit. These imperfections arise from two sources:

● demand: a lack of knowledge about the potential of venture capital and the process of becoming investor ready

● supply: commercial interests of fund managers to supply an attractive return to their investors means that lower risk/higher return projects are preferred to higher risk equity type projects at the SME growth end of the industry. This is not a matter of the size of investment but, critically, concerns the potential return from any such investment.

The IPPR research suggests that venture capital in itself is not a panacea for providing suitable funding for SMEs. Policy should also take into account:
the clear gap for companies seeking investments of between £250,000 and £750,000 in the market. This derives from a funding gap which is the result of a mismatch between perceived risk and perceived return, and a knowledge gap which is the result of imperfect information about the benefits of venture capital and about investment opportunities. Both can, and should, be addressed by government policies to guarantee risks and to improve information flows.

The need to enhance the operation of existing structures rather than entrench the imperfections apparent at the equity gap end of the market. Any money directed towards co-investment in regionally based funds will simply exacerbate the upward spiral of average investments.

The need to incorporate the venture capital industry itself. Experienced fund managers and business related professionals (lawyers and accountants, for example) are expensive and represent an ongoing cost. While all regions anticipate that the management costs of the fund would eventually be borne by the profitability of the fund itself, this profile and track record takes time to develop. Since funds from the DETR are for regeneration rather than competitiveness, the RDAs claim that they cannot afford to subsidise the fund management cost in the short run.

Further, there is an assumption that the regional funds will be profitable. Unless the government role can be directed towards addressing the issues around investment and return, this is by no means clear. The funds will only be profitable if they make investments that provide a return. The projects envisaged by the Government as being suitable for this investment may not be those which guarantee return to investors. Policy has to take into account the economic imperatives facing the industry.

The market appears clouded by the swathe of initiatives from different government departments. For example, no interviewee was clear on the relationship between the Small Business Service (nominally charged with running the Enterprise Funds), RDAs (charged with setting up but not running or managing the Enterprise Fund) and the existing Business Links.

Further confusion arises from DETR’s coalfield fund (the definition and practical uses of which seem unclear to practitioners) and the DfEE’s University Challenge funds which, although to be welcomed, do not have a clear link through to the development of regional enterprise funds. This confusion adds to marketplace imperfections presenting a chaotic picture to most of the research participants. A clear, centrally co-ordinated policy statement on the links between regional funds and other initiatives is vital if regional funds are to be at all effective.

So where does this research leave government policy in these vital areas? There is a role for government involvement in the venture capital industry, but creating market distortions through that involvement will not improve the situation. In particular the Government has to be aware of two things. First, it must not put money into the market at a point that exacerbates the problem. The danger with investing in a fund that expects a commercial return is that it enhances the existing trend towards upward spiralling average investments. Second, there is little to be gained from providing direct subsidy to management costs in the long run, since this again simply puts money where it already exists.

Meanwhile, RDAs have a key role. By creating knowledge gap-filling mechanisms they can be effective in changing culture. By creating finance gap-filling tools they can engender the flexible funds that do encourage innovation and growth, as they have in the US and Germany.