Crossing the chasm

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CROSSING THE CHASM: THE ROLE OF CO-INVESTMENT FUNDS IN STRENGTHENING THE REGIONAL BUSINESS ANGEL ECOSYSTEM

Abstract

Government intervention to improve the supply of early stage risk capital has taken a number of forms, the most recent of which is the establishment of public/private co-investment funds. This paper provides a detailed case analysis of the earliest such fund, the angel-led Scottish Co-Investment Fund. The fund as a pari passu investor alongside private sector investors, has had a number of key impacts on the risk capital market in Scotland: business angels account for 73% of all transactions; SCF has leveraged additional funds into deals; SCF allows investors to consider larger deals and commit to follow-on deals than their liquidity and investment preferences would otherwise allow; SCF plays an increasingly important role in the development of those ventures who would otherwise struggle to attract institutional VC; and it has stimulated the organisational transformation of the business angel market in Scotland into one dominated by business angel groups and syndicates.

Key words: co-investment fund; business angels; equity gap; risk capital market; policy; entrepreneurial ecosystem; Scotland

CROSSING THE CHASM: THE ROLE OF CO-INVESTMENT FUNDS IN STRENGTHENING THE REGIONAL BUSINESS ANGEL ECOSYSTEM

Introduction

The efficient and effective provision of risk capital is a prerequisite for economic development. This is not, of course, a new insight but one which has dominated policy and practice in this area for over two decades: 'developing risk capital in the European Union, leading towards the development of pan-European risk-capital markets, is essential for job creation in the UK' (CEC 1998). At European level, this awareness can be traced back to a commitment given at the EU Lisbon summit in 2000 to promote the creation of risk capital funds throughout the EU to address the recognised gap in the availability of equity finance for start-up and early stage ventures, and hence stimulate job creation and economic growth. The identification of a role in this for the public sector is consistent with what we know about the evolution of venture capital markets more generally, in that the development of these markets necessarily involves government support: 'all venture capital markets of which we are aware were initiated with government support. These markets do not appear to emerge without some form of assistance. This leads to the question as to what it is that requires the need for government support for these markets, at least in their formative stages' (Lerner et al 2005; Lerner 2009).

Discussion of the role of equity investment (venture capital and business angel investment) usually centres on the issue of the equity gap: a shortage in the provision of finance to growing or growth-orientated smaller businesses. This equity gap, to the extent to which it exists beyond an efficient and rational risk-reward adjusted supply of capital, reflects market failure (Murray and Lingelbach 2009), and may be manifest in some combination of the restricted supply of capital from investors, the lack of effective demand from investment ready businesses and information and signalling inefficiencies in the operation of the market. This can be seen as a general problem faced by companies in terms of access to equity finance on appropriate terms and conditions, or as a problem for particular types of companies (for example, those seeking a particular size of investment, at a particular stage of business development, in particular locations or using particular technologies) (Harrison and Mason 2000).

This equity gap has been captured in the metaphor of crossing the chasm: the start-up and early stage new venture faces an often unbridgeable capital chasm – the funding requirements for proof of concept, proof of market and commercialisation – between the start-up phase and the possibility of sustainable long-term growth. For a number of years it was believed that business angels played an important role in bridging this chasm through the so-called funding escalator, the argument that complementarities in the risk capital market meant that new ventures could move from initial self-funding through affinity investment from family and friends before raising investment from business angels and subsequently venture capitalists before going for a trade sale or IPO for further fund raising or exit (Mason and Harrison 2015). However, post-global financial crisis (Harrison and Baldock 2015), and despite some lingering adherence to the metaphor (British Business Bank 2015), this funding escalator has collapsed and the early stage risk capital market has become more fragmented (Owen and Mason 2016). The chasm, in other words, has become both deeper and wider. Indeed, given the persistence of regional variations in access to capital, it can be argued that the funding escalator as the relatively seamless transition from one source of investment capital to another only ever existed in core economic regions and entrepreneurial hotspots with strong entrepreneurial ecosystems. Outside of these it is not so much that the funding escalator is broken but that it never functioned in the first place.

In either case, market failure or the collapse of the funding escalator, this has prompted consideration of public sector intervention, and there have been a number of public sector initiatives to address these gaps in the supply of risk capital by stimulating the supply of equity investment. These initiatives have taken one of two forms: in some cases government has become directly involved as an equity investor (by investing in private sector VC funds or establishing directly funded VC funds); in other cases, government has sought to catalyse the market by supporting the creation of private sector funds (offering tax incentives to offset risk and increase the returns to investors, providing equity guarantee schemes to reduce risk for investors, and reducing appraisal and running costs by subsidising funds directly) (Murray 2007). The recent emergence of co-investment funds as public/private partnerships represents a further shift away from direct government intervention in the market, which is justified on the basis of the absence of unequivocal evidence on the impact of more direct support (see for example, Brander et al 2014; Grilli and Murtinu 2014a; 2014b; Söderblom et al 2015; Cumming et al 2017). Although there has been some discussion and evaluation of some models of co-investment schemes (Owen and Mason 2016), there is little systematic evidence on their operation and effectiveness (Tillväxtanalys 2013; EBAN 2016; OECD 2011; Wilson and Silva 2013).

The objective of this paper is to contribute to this sparse literature in two respects: first, by undertaking, using published and unpublished data obtained from the Fund administrators, a detailed analysis of the design, operation and impact of the longest established and widely imitated co-investment fund, the Scottish Co-Investment Fund, launched in 2003; and second, by identifying the impact of the fund on the supply of early-stage risk capital and on the structure of the entrepreneurial finance market. The paper is structured as follows. The European policy context for the development of co-investment funds is set out in the next section. The following sections describe the background to and context of the Scottish Co-Investment Fund, its design, operating procedures and investment partners. This is followed by an analysis of the investment activity and impact of SCF for the periods 2003-2009 and 2009-2013. The paper concludes with a discussion of the wider implications of this case study.

Co-Investment Funds: The European Context

Although of relatively recent origin, there are now reported to be over 150 co-investment and related funds in 23 European countries, where a co-investment fund is defined as an 'investment mechanism that results mainly from a public-private partnership between the State/Government and business angels for investments in early stage start-ups' (EBAN 2016,9). While a number of co-investment models and structures exist (Owen and Mason 2016), for the most part these funds are characterised as follows: they comprise an investment fund dedicated to the provision of equity finance to SMEs in which business angels and/or other private sector investors have committed to invest provided they can source a co-investor; the co-investment fund invests under the same terms and conditions as the angels on a pari-passu basis; the fund is run by an independent fund manager who uses to a large extent the due diligence work carried out by the business angels to reduce costs; and funds can be managed by business angels, venture capitalists, public authorities, private equity groups or any combination of these (EBAN 2016). The purpose of the funds is to support economic growth through innovation-supporting new business development by helping angel investors, as a key component of an effective entrepreneurial ecosystem (Spigel and Harrison 2017), share risks through portfolio diversification and improve investment capacities by leveraging additional capital. However, while it is believed that co-investment funds may at least double individual business angel investment, 'given the recent establishment of most European schemes, we still do not have enough information available in order to measure precisely such impact' (EBAN 2016, 19).

Given this, examination of the Scottish experience, which is the primary focus of this paper, is instructive for three reasons: first, the region has a long tradition of public sector support for the early stage risk capital market and for public/private partnerships within this (Hood 2000); second, the business angel market in Scotland is larger, in relative terms, more highly developed and more organisationally complex than in other European regions, reflected specifically in the growth in the number and size (membership) of business angel groups (Harrison et al 2010; Gregson et al 2012; Mason et al 2016; Kemp et al 2017); and third, it has experience of an angel-led co-investment fund since 2003, one of the earliest co-investment funds to be established and the model for others (including New Zealand), analysis of the design and delivery of which may have implications for other European regions (Harrison et al 2010; Lerner 2010).

The Scottish Co-Investment Fund

In the case of Scotland, there has been a major evolution in the nature of government support for an emerging venture capital industry. Initial efforts were focused on direct funding, through the creation of a directly funded, public sector managed VC fund (Scottish Development Finance) within the regional development agency as a core service of the agency from its inception in 1975 until its privatisation in 2000 as Scottish Equity Partners (Hood 2000). More recently, the focus has shifted to indirect support for private sector players in the market. The overall policy context for this shift has been clearly articulated: 'Enhancing the quality and focus of support for business and innovation will have a direct impact on business competitiveness and growth. Responsive, accessible business support services will allow all areas of Scotland to contribute to and benefit from a shared approach to economic growth' (Scottish Government 2007). Specifically, 'the Strategy should not be to pick individual companies as winners – the market does that. Rather, the job of government should be to facilitate and accelerate the growth sectors and to provide the necessary environment to make sure that it happens in Scotland.'

It is within this context that the Scottish Co-Investment Fund (SCF) was set up as a £72m equity investment fund established by Scottish Enterprise in 2003. It was part-funded by the European Regional Development Fund and targeted investments between £100k and £1m in equity investment deals of up to £2m in total value. It sits as one of three linked funds – the Scottish Seed Fund, which is directly funded by Scottish Enterprise with a £2m annual budget allocation for the current year, provides funding in the range £20k to £100k and the Scottish Venture Fund, capitalised at £50m to be invested over a five year period, provides funding in the range £500k to £2m (Figure 1). This initial iteration of SCF was active until the end of 2008, when it was relaunched as part of a new cycle of ERDF funding (Scottish Investment Bank 2017).

Figure 1 about here

Although full evaluation of the impact of government support for the risk capital market requires data on exits and fund performance (Munari and Toschi 2014), the immediate headline impact of SCF has been significant. In general terms, there is a clear regional division in the UK in terms of the role and significance of public sector involvement in equity investment (Mason and Pierakkis 2013): in London and the South East, equity investment is primarily from private sector sources whereas in the remainder of the country in it primarily from the public sector, either directly or from public/private initiatives. Scotland is the exception: although private sector investment is relatively low, there is much less public sector only investment than in other non-core regions, and around 50%[1] of recorded investment (based on Library House data) is from private/public sources, of which the SCF is the most significant.

[1] This figure for investment is significantly higher than that recorded in successive Scottish risk capital market reports, suggesting significant undercounting in the Library House data.

Using transaction data that charts the actual flow of investment into ventures in Scotland (rather than the announcements of commitments of funds yet to be drawn down), it is clear that transactions where there is a public sector involvement, primarily through the Scottish Co-Investment Fund, were important in the overall risk capital market. In 2007, for example (by which time SCF was fully operational) public sector involvement, including investment from SCF and other publicly-backed equity investors such as University Challenge Funds, was recorded in 43% of all risk capital market transactions in Scotland (Table 1) and this investment represented 12% of the value of all identified risk capital investment (by VC funds and business angels) in Scotland in that year, rising to over 30% in some areas (Table 2). This pattern had been established very quickly after the establishment of SCF, reflecting the post-dotcom crash illiquidity in the market which in part triggered its formation: early reports on the Scottish Risk Capital Market, which track every recorded investment in unquoted companies in Scotland, demonstrated that there was public/private sector investment recorded in between 40% and 44% of all transactions (Don and Harrison 2006; Harrison and Don 2004; Glancey et al 2008). Over the last eight years (2009-2016) SCF II and other public sources of equity finance have accounted for between 7% and 30% annually of all identified risk capital investment in Scotland (data on the proportion of all investments including SCF/public money are no longer reported). Given the close link between SCF and angel investment, this proportion is counter-cyclical to the institutional VC investment cycle: when VC investment is low (as in 2009-11) the SCF/public investment share is high, and when VC investment is high (as in 2013-16) this proportion is low.

Tables 1 and 2 about here

Given the significance of this investment in the Scottish risk capital market, and the fact that the co-investment fund is one of the longest established co-investment funds in the UK, and one which is distinctive in terms of its *modus operandi*, as a passive angel-led initiative, a case study of the development, operation and impact of SCF during the period 2003-2009 will provide lessons for better understanding of the operation of the early stage risk capital market and of the role and potential for public sector support of that market. This is important, as Lerner (2009), notwithstanding his belief that no venture capital market has come into being without government support in one form or another, argues strongly that on-going public sector involvement in venture capital markets is counter-productive. A case analysis of SCF will demonstrate how public sector interests and private sector expertise and standards can be combined effectively. Following discussion of the background to and evolution of the co-investment fund, this paper will focus on providing a detailed analysis, based on unpublished data, of the operation and impact of the first iteration of the scheme in operation over the period 2003-2008, which was a critical period in the structural evolution of the risk capital market in Scotland as institutional VCs largely withdrew from investing in the region and as the organisation of the angel market saw formal angel groups and syndicates progressively replace individual investors, itself a development facilitated if not stimulated by SCF (Harrison et al 2010; Kemp et al 2017). The final section of the paper will briefly update on the subsequent experience of the revised scheme – SCF-II – over the period 2009-2016.

Background and Policy Context

The evolution of UK policy since the EU Lisbon summit in 2000 has continued to reflect concerns about access to risk capital in the regions. As a result, there has been renewed policy interest in recent years across the United Kingdom, based around the development of institutional innovations to reflect and deal with the need to avoid distortion of the market, or crowding out of other providers, through non-commercial operations, the need to develop and apply best-practice venture capital investing skills and experience, and the need to address the constraint on the development of new venture capital funds in the regions arising from the largely fixed operating costs of funds. In 2002 the UK Government announced, not without criticism, the establishment of nine Regional Venture Capital Funds with a budget of £270m, of which £80m was to come from Government (Mason and Harrison 2002).

In Scotland, the withdrawal of existing VC investors from the Scottish market following the dot-com crash, liquidity constraints faced by individual angel investors and by angel syndicates and increased reports of good companies failing to raise equity capital led to a review of public sector equity policy in Scotland in 2002. The outcome was the introduction of a number of measures, including the Scottish Co-Investment Fund to provide equity finance of up to £500,000 (raised in 2007 to £1m in deals of up to £2m) to potential high growth companies through selected private sector partners. While the Fund operates as a single Fund, for ERDF purposes the single SCF is analysed as two distinct projects depending on whether the Fund was match-funded from the 2000-2006 or 2007-2013 ERDF Programme[2]. The last investment in SCF was made in November 2008; from then on investments are classified as part of SCF II. The operation of the Fund was consistent with the then most recent statement of economic policy in Scotland: in terms of investment, the current strategy in Scotland is to 'address gaps in access to capital that are constraining Scottish businesses from reaching their full potential, whilst helping to build capacity in the investment community to remove barriers to investment' (Scottish Government 2007). In addition to equity funding, there was also put in place a regional investment readiness scheme that provides advice and grant support to help develop the demand side of the market by assisting the preparation and development of investible propositions.

Design and Operation of the Fund

Unlike the RVCFs in England, which have the UK Government as a direct investor, albeit in a subordinate position in which its returns are capped and it acts as 'first loss' in the event of an erosion of the capital base of the fund, there is no public sector investment in a managed partner fund. Unlike a standard VC fund or business angel investor the SCF does not find and negotiate deals of its own. Instead it forms contractual partnerships with active VC fund managers, business angels and business angel syndicates from the private sector. These partners find the opportunity, undertake the due diligence, negotiate the terms of the deal and commit their own resources to the equity investment. If the opportunity requires more investment than the partner can provide it can call on SCF to co-invest, directly into the opportunity, alongside on equal terms. It is the SCF Partner that determines how much the SCF can invest in a deal, subject to the requirement that under the terms and conditions for the operation of the Fund (governed by state aid rules and the conditions associated with the ERDF funding of the programme) the SCF cannot invest more than the SCF Partner. Companies seeking investment approach partners directly, and the SCF itself has no influence in the investment decision making process at any stage, which is delegated to the private partner funds.

SCF funds are not placed into a limited partnership agreement with the partners; instead, the agreed funding is legally guaranteed by SCF, and SCF funds are only drawn down from Scottish Enterprise (Scottish Investment Bank) once an individual investment has been legally concluded and subject to assurance that the eligibility criteria have been met (see below). Partners are paid a flat fee of 2.5% of the SCF funds invested, and are awarded partnership status with SCF for a three year period – this agreement includes an allocation of funds that will be available for draw down over that period, reviewed on a six monthly basis and on the basis of an annual review of partner performance.

[2] Information on SCF taken from http://www.scottish-enterprise.com/invest-scottish-co-investment-fund accessed 01-07-2009. See also Hayton et al (2009) and Watson M (2017)

The operation of SCF was as follows. First, a company approaches a SCF partner for investment and progresses through their screening and evaluation filters. Second, early in the process the partner informally notifies Scottish Enterprise (now Scottish Investment Bank) that they are working on a prospective investment and that they will be inviting SCF to join them in the deal – this allows SE to check that the prospective deal fits the basic size, sector and location eligibility criteria. Third, confirmation from SE that these basic criteria are met comes in response to the partner's submission of a formal Notification within a couple of weeks; at this point the partner is advised that if they invest SCF will, on the basis of the information provided, co-invest with them, subject to satisfactory legal documentation, and SCF does not undertake its own due diligence of the deal but relies on the judgement of investment partners on which it has undertaken due diligence before admitting them to the scheme. Fourth, the partner sets up the investment deal in the usual way and nominates a target closing date for signature of all investment agreements and payment of all monies – before this date the partner will, as noted above, have formally notified SE that they want SCF to co-invest, which will have included a detailed memorandum setting out the terms of the deal, the targeted closing date, the other parties to the deal and any other relevant deal-related information, confirming also that the terms of the deal are *pari passu* and contain Scottish Enterprise's standard investor controls. Fifth, SCF will, subject to its compliance regime, invest in whatever type of share, loan stock or convertible preference share that the business agrees with the partner, and invests pro-rata with the partner investor on the same terms and conditions (the amount invested by SCF is determined by the partner, who will call down investment from the capital pool allocated to it [see Table 3 below] to a level needed to complete the deal, subject to the maximum SCF permitted). Sixth, SE is also involved in the preparation of legal documentation and the completion procedure is contemporaneous with that of the partner.

The fundamental operating principle for SCF from the outset was that it should operate at minimal cost to the public purse 'on a fully commercial basis and will not provide any form of subsidy or guarantee to SCF partners or the individual companies that SCF partners invest in. Also the SCF in applying a fully commercial approach will make investments that require no subordination of public funds. In effect as a genuine co-investment vehicle the entire operation of the Fund will be on an equal risk, equal reward terms (*pari passu*) between the private and public investors. As such it respects state aid rules' (SCF Business Plan 2003, cited in Hayton et al 2008).

Companies are eligible for SCF investment if they meet a number of criteria: they are incorporated; have less than 250 employees; have net assets of less than £16m; are in an approved business sector;[3] are doing a deal below the set maximum deal size (£2m); are doing a deal which involves the sale of an equity interest (SCF does not invest in pure debt, though debt may feature in a transaction that has a material equity interest at its core); are taking that investment from an approved SCF investment partner; and are predominantly located in Scotland[4], as SCF is geographically constrained in its investment activity. In terms of deal characteristics, SCF can invest up to a maximum of £1m in any one individual company, either in one tranche or in multiple rounds, and total deal size, including any debt component, should not exceed £2m. The investment must be at least matched pound for pound by the partner and the terms of the deal must be without partiality to the partner. Scottish

[3] Exclusions include: dealing in land, commodities, futures, shares, securities and other financial instruments; banking, insurance, money lending, debt factoring, hire purchase financing and other financial activities; leasing or letting assets on hire; providing legal or accountancy services; property development; farming, forestry or market gardening; operation or managing hotels, nursing or residential care homes; retail sectors if there is a trade displacement issue with other local businesses.

[4] This is primarily measured by considering: location of main or head office; location of majority of staff; country of registration of the operating company; and location of the majority of executive directors, to assess a company's 'centre of gravity'. SCF investment is restricted to investment in Scotland.

Enterprise/Scottish Investment Bank cannot own more than 29.9 per cent of the voting rights of a company, including those acquired through other investment schemes previously invested by Scottish Enterprise, and public money cannot account for more than 50 per cent of the total risk capital funding in a deal.

SCF Investment Partners

By 2008 there were a total of 34 SCF investment partners listed with allocations under SCF I or SCF II; of these, 16 were selected from the first 34 applications received in response to the advertising of these opportunities on the Official Journal of the European Union. The remainder have been added to the list of partners since the inception of SCF. The majority of partners are Scottish-based, but a number are based in England (mostly London) or in continental Europe. As the SCF has continued to develop, there has been a shift in focus in the nature of the partners. Initially, reflecting the fact that SCF was established in its current form at least in part in response to pressure from business angel groups in Scotland, established business angel syndicates dominated. This can be seen in the allocation of funds (Table 3) – the four partners with the largest allocations under SCF (accounting for 61.9% of the total allocation) are business angel syndicates, one of which also runs an investment fund with a separate allocation. In total this partner received around 24.6% of SCF resource commitments in the 2006-2008 period. Under SCFII, as new partners, many of them VC and corporate investors, have joined the Fund, there has been a further shift away from small scale allocations: whereas 23.5% of allocations in SCF I were for £500k or less, only 14% in SCF II are in this range, and allocations of over £4m have risen from 22% to 37% of the allocations (Table 3).

Table 3 about here

It is also reflected in the distribution of deals since the inception of the SCF: business angel-led deals still dominate, but the proportion accounted for by VCs and other partners has been growing, a trend which has continued into 2009 under the first tranche of allocations under SCF II (Table 4). Business angel investor groups are the four most active investors over the life of the SCF to date, accounting for 43% of the companies invested in since the inception of SCF. Over the life of the Fund to date angel syndicates account for 50% of the registered partners and individual angels account for a further 11%. Together they account for 68% of all company deals, for 73% of all transactions and for 67% of SCF investment. While it might be expected that angel investors (individuals or syndicates) would account for a higher proportion of deals, given the widespread evidence that they will tend to make smaller investments on average than institutional investors, the fact that they account for almost the same share of transactions as deals suggests that SCF has made it possible for angel investors to provide follow-on funding to portfolio companies. This is reflected in the fact that there are 2.11 angel investor transactions on average per company compared with only 1.97 VC transactions per company. Given that the inability of angel investors to 'follow their money' was identified as a major issue in the consultations leading up to the establishment of the Fund, these figures represent a significant success in addressing this aspect of market failure in the Scottish early stage risk capital market. Table 4 also confirms that venture capital investors are associated with larger than average deals (about half as large again as the average SCF investment): SCF does appear to be effective in mobilising VC investment into the lower end of the regional equity gap, in part at least addressing the problem of the 'flight' of VC from Scotland in the post-bubble period (Harrison et al 2010).

Table 4 about here

Furthermore, SCF has been effective in leveraging additional funds into investee companies (Table 5): although SCF can invest up to a one to one match with partner investment, the actual leverage is much greater than this, averaging 1:2.50 since the launch of SCF in 2003 and ranging from 1:2.02 to 1:2.74 across the partner types. This suggests that SCF is making a significant contribution to the mobilization of additional risk capital in Scotland. In all partner types and for VC partners in particular, there is significant involvement of private sector investors other than the partner in transactions, pointing to the significance of syndication in the early stage risk capital market. Of each additional £2.23 that the Fund leverages, £1.38 comes from the partners themselves; £0.80 comes from other private sector sources; and £0.05 comes from other public sector sources. Overall, these figures suggest SCF has been successful both in leveraging partner investment, allowing the investment partners to invest in more deals and to follow-on their investment, and in leveraging in additional non-partner investment through syndication and coinvestment activities initiated by the partners. The overall outcome was a significant increase in the early stage risk capital investment available to companies in Scotland.

Table 5 about here

SCF Investment Activity

Between 2003 and 2008 SCF has supported 220 investments in 118 different Scottish companies (Table 6) for a total SCF investment (not total transaction investment) of over £33m at an average of just over £150k per SCF investment and a range of £4600 to £500k[5]. There is evidence that the staging of investment is common: only 51 companies have received a single investment from SCF: 67 companies have received multiple investments (up to five in some cases), at an average of 2.52 investments per company over the 6 year period. Given that one of the rationales for establishing SCF was the perceived lack of liquidity in business angel syndicates in 2002-2003, this evidence suggests that the Fund has been successful in allowing such investors to follow their money and make follow-on investments in their portfolio companies which would not otherwise have been possible. However, the fact that some investee companies have received up to five rounds of investment under SCF also suggests that there is an emerging segmentation in the risk capital market, in that these companies have not managed to attract purely private VC investments.

Table 6 about here

Almost half of SCF investments have been for amounts under £200k, but a quarter have been investments of £500k or over per transaction (Table 7). Investments to date made under the first tranch of SCF II (including recent investments not included in Table 6) are smaller on average than those under SCF, with 78% under £200k – this may reflect changes in the pattern of demand from investee companies in a recessionary economic climate, changes in the valuation and pricing of deals, and may also reflect the addition of new partners, including a number of individual business angels, to the Fund. There is a strong sectoral concentration of investment, with software, medical/health, biotechnology and electronics dominating – this is consistent with the wider evidence on investment activity in the early stage risk capital market in Scotland.

Table 7 about here

[5] This is a more limited analysis than the figures quoted in the previous section, as a function of the availability of detailed data for analysis.

In terms of regional distribution within Scotland, there has been a long-standing concern that venture capital and angel investment has been disproportionately concentrated in the East of Scotland, in the greater Edinburgh region (Gray nd; Harrison et al 2010). From Table 8 it is clear that the Central Belt dominates in these figures and that there is still a concentration of investment activity in the east of Scotland. Overall, the proportion of investment activity in the East (SE East Central Scotland and SE Tayside) has risen in SEFII, from 53% to 62%, and exceeds the region's share of registered businesses in Scotland (33%). The share of SCF investment in the West and South of Scotland (SE West Central Scotland and SE South of Scotland) has fallen from 39% to 29% from SCF to SCF II, against a share of registered businesses of 40%. As noted elsewhere, the Highlands & Islands and Grampian regions account for a disproportionately small share of investment activity relative to the size of the economy (Glancey et al 2008). In part this reflects the location of SCF partners: of the 29 current partners listed on the SE website in July 2009, 12 were based in the East of Scotland, 8 were based in the West and South and 2 were based in the Highlands and Grampian region. Seven partners were based outside Scotland and the potential leverage of investment capital not controlled from within Scotland from these partners represented an additional contribution of SCF to the development of the risk capital market in Scotland.

Table 8 about here

In terms of the investment instruments used there is a wide variety reported. As expected, ordinary shares (unlisted, 'A' and 'B' class) dominate (89%) (using data on all SCF investee companies, including those no longer trading), with very limited reported use of preference shares (1%). Loan notes (mostly convertible) represent around 6% of SCF investments.

Impact of SCF

The scale of SCF, in terms of mobilizing investment capital, has already been commented on: in total, SCF was represented in over 40% of the identifiable risk capital market deals reported in Scotland in each of the years of its operation. Further evidence of the impact of SCF is available from two reviews of the Fund and from the report on ERDF supported activity prepared by Scottish Enterprise.

An evaluation of all ERDF supported risk capital schemes in Scotland (Scottish Executive 2008) drew the following conclusions. First, full or partial additionality of the SCF was over 90%, when considered from both the investment partner and the investee business (survey evidence suggests that for 92% of businesses, investment capital was either not available or not available in sufficient quantity to meet their needs). Second, the SCF model had helped develop the local financial community by increasing the deal capacity of investment partners and attracting investment partners not previously involved in company finance in Scotland. Third, the structure of SCF, with investment partners bringing deals to SCF, ensures that there is no displacement of private sector finance providers – indeed, the evaluation concluded that SCF is likely to enhance the market rather than displace other providers because it only invests in deals that are brought to it by other investors.

Second, the SE-commissioned evaluation of SCF (Hayton et al 2008) concluded that: first, over half of SCF investee companies felt that their chances of raising capital elsewhere would have been 'poor' without SCF and 78% stated that the fund had been 'vital' to their business survival; second, SCF has had and is forecast to continue to have an economic impact on the companies that have been supported, in terms of identifiable increases in turnover, gross value added and employment; third, SCF supported companies perform better than companies generally in Scotland (although there is a selection bias in this, in that it is the more dynamic growth-orientated companies that will seek out equity investment in the first place); and fourth, the majority of sales of SCF investee companies are outside Scotland, suggesting that the displacement of other economic activity in the region will be low.

Finally, the SE annual report on SCF[6] includes evidence on performance to date against ERDF targets (Table 9): this shows that the number of new SMEs receiving investment has been slightly behind target, the number of existing SMEs receiving investment was around 20% below target, the total number of gross new jobs created was ahead of target (and will be expected to rise as investee businesses continue to grow to their full potential following equity investment from SCF and its partners), the turnover increase in investee businesses is over twice the target (based on an earlier survey-based evaluation) and private sector leverage is also almost twice the target.

Table 9 about here

Overall, therefore, from this analysis of SCF over the 2003-2008 period it appears that SCF has been effective in supporting the mobilization of additional risk capital in Scotland, and in particular has enabled business angel investors in particular to follow their initial investments in new and growing ventures through multiple rounds in the absence of participation from other private sector investors. However, the fact that SCF is still involved in up to fifth round investments in some companies points to a possible segmentation in the Scottish risk capital market, with existing investors (business angel syndicates and some early stage VC and corporate investors) taking portfolio companies through multiple rounds but with little or no participation in follow-on finance from private sector VCs outside the SCF. This absence of private sector VC at later stages of business development remains a structural weakness of the Scottish risk capital market (Harrison et al 2010).

The picture updated: SCF II 2009-2013

SCF II commenced operation in January 2009 with the same rationale, to address a structural market failure in the supply of risk capital to early stage growth potential ventures which was still identified at UK and Scottish levels (British Business Bank 2015; van der Schans 2015; Royal Society of Edinburgh 2014). Over this five year period SCF II invested £45.5m in 139 businesses, leveraging a further £74.6m in private sector investment from 29 accredited partners for a 1:1.64 public/private leverage ratio (Watson 2017). In total, between 2003 and 2013 SCF and SCF II invested £95m in 335 businesses in Scotland.

There have been a number of emerging trends in investment under SCF II (Watson 2017). First, investment under SCF II has been falling year on year, and was 40% lower in 2013 than in 2010, suggesting that the early stage risk capital market in Scotland is maturing and that SCF II plays a role, but no longer a dominant one, in that market. Second, SCF II still remains a significant part of the market: in 2012 and 2013 there was some £82.5m invested in the SCF II deal space (£100k-£2m) (Scottish Investment Bank 2013, 2014), of which £14.2m (17%) came from SCF II. Third, follow-on investment has become progressively more important, at the expense of first-time investment in growing companies, rising from 11% of total investment in 2009 to 40% in 2013, and confirming earlier arguments that as institutional VC has continued to withdraw from the regional funding ecosystem (with the exception of largely one-off blockbuster deals (Don and Harrison 2006)) business angels are increasingly responsible for cradle to grave funding for their portfolio companies in which SCF II

[6] Scottish Co-Investment Fund Annual Report for the year to 31 March 2008; the table includes updated data for the final claim against the 2000-2006 ERDF Programme (last investment against this – November 2008)

continues to play an important role (Harrison et al 2010). Fourth, there remain some concerns about the low level of exits from SCF II investments: although some £1.4m in net income to the fund was reported up to 2012/13, with cumulative write-offs running at 4.2% of total investment and income received from disposals and loans repaid running at 7.7% of investment, wider evidence suggests that where exits are occurring, they are doing so after around 10 years post-investment rather than the seven years planned for when SCF II was established (SIB 2016; Watson 2017; Harrison et al 2016). Fifth, there is increased evidence for the syndication of deals among fund partners: some 17% of SCF II investment has been drawn down in multiple partner investments and the two most active individual partners, both Edinburgh based, account for a further quarter of all SCF II investment drawn down (Figure 2), reinforcing the pattern observed in the original SCF. Sixth, the risk capital market continues to evolve, most recently with the development of equity crowdfunding (Tuomi and Harrison 2017), with as yet unknown implications for the operation of co-investment funds.

Figure 2 about here

Based on interviews with both investment partners and businesses in receipt of SCF II investment (Watson 2017) it appears that the fund continues to have a positive economic impact: investee businesses almost without exception report that SCF II investment is instrumental in supporting and sustaining growth, additionality is high, reflecting the absence of alternative funding sources as VC investment and debt funding continue to be inaccessible, and displacement is minimal, given that these businesses serve mainly non-local markets, experience low levels of domestic competition and sell into growing markets. Estimates of the economic contribution of SCF II in 2015 suggest that it is responsible for net additional gross value added of £31.4m, reflected in a value for money ratio of 1.5:1, and net additional employment of 240; these figures are expected to rise by 2025 to net GVA of £290m, a VFM ratio of 13.6:1 and net peak additional employment of 660. Finally, there is little evidence of agency problems in terms of adverse selection or moral hazard in the operation of the fund. Partners are not using the availability of SCF II to invest in higher risk deals than they would have otherwise considered, there appear to be no differences in how business angel groups and syndicates evaluate SCF and non-SCF investments and partners do not appear to be routing their higher risk or more marginal deals to SCF II. This is reflected in the fact that in only one or two cases (recently formed groups) is risk sharing identified by partners as a benefit of co-investment.

Conclusion: Lessons from SCF

The design of the SCF, with the fund as a *pari passu* investor alongside private sector investors, has had a number of key impacts on the risk capital market in Scotland. First, *leverage* – SCF has leveraged additional funds into deals, with the leverage rate sitting at around 1:2.26 as against an anticipated rate of 1:1 at the inception of the scheme. Second, *speed* – the design of the SCF ensures that investment decisions are taken by private investors, with the Fund decision to co-invest being given in the form of a speedy assurance that up to 50% of the funds needed to complete an investment transaction will be available for eligible deals. Third, *design* – the SCF is dominated by business angel syndicate partners, who are key players in the early stage capital market, and the availability of SCF addresses the liquidity and investment appetite issues for syndicates hit by the need to provide follow-on funding for their portfolio companies after the withdrawal of VC investors from the market in Scotland in 2001-2002. Fourth, *deal size* – the availability of SCF allows investors to consider larger deals and commit to more follow-on deals than their liquidity and investment preferences would otherwise allow, and makes it possible for companies to raise all the investment they require. Fifth, *leverage and syndication* – the Fund has successfully leveraged additional investment from private sector investors in addition to that from partners, and provides clear evidence of increased syndication in a maturing Scottish early stage risk capital market. Sixth, *additionality* – in providing additional investment liquidity for partners the SCF helps extend the funding pipeline rather than replace existing investment: in view of the evidence from the annual reviews of the risk capital market in Scotland that the risk capital market is separating into a market dominated for the most part by business angel investors on the one hand (supplemented with a small number of early stage institutional VC funds) and VC investors interested in much larger deals on the other, SCF plays an increasingly important role in the development of those ventures who would otherwise struggle to attract institutional VC.

This design avoids the common criticisms of public sector intervention in venture capital markets, in that it removes the state from the decision making and fund management processes, relying instead on the private sector to make all investment decisions, and it avoids introducing distortion into the market, assuming a position as a *pari passu* investor rather than as a subordinate investor accepting lower or capped returns and taking the first loss on erosion of fund capital. As such, this fund design offers the prospect of mobilizing investment capital within a regional economy from existing investors, by enabling them to do more and larger deals, attracting investment capital from investors outside the region, addressing one of the weaknesses of regional economies with weak indigenous VC markets, and doing so in a manner that minimizes the cost to the public purse and the risk to public funds. For policy makers this case study demonstrates the value of public-private co-investment platforms in mobalising and making available additional risk capital in otherwise capital-deficient markets with little or no early stage venture capital availability at a much lower cost and risk than, for example, direct intervention by creating public sector venture capital funds. For entrepreneurial growth ventures co-investment initiatives not only incease the supply of risk capital in a region but also increase the capacity of individual angels and angel groups to undertake follow-on financing to support the venture growth and internationalisation process.

The evidence to date is that this approach works, and that as a result Scotland was estimated at the end of this period to have the most generous and effective framework for the support of risk capital investment in early stage companies in the UK (Library House 2009). While effective, however, the SCF model is not universally applicable, in that it rests fundamentally on the prior existence of credible experienced investors, primarily organised into groups and syndicates to whom can be delegated the investment appraisal and due diligence process. In providing an opportunity for the public sector to play a passive role this has the advantage of reducing fund operating costs vis a vis a managed fund structure and avoiding the public sector partner in ostensibly ‘picking winners' and second guessing the market. The evidence suggests that in circumstances such as Scotland, where there was already a developing risk capital market, an angel oriented co-investment fund can play an important role in the further development of that market, allowing existing investors to do more and larger investments over multiple rounds, and helping to bring new investors into the market. However, the challenge of kick-starting the market where these initial conditions do not obtain remains a major challenge for policy.

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Table 1: Number of SE/HIE* Investments relative to all investments by Geography, 2007			
Region	**SE/HIE Involved**	**All Investments**	**SE/HIE percent**
South	1	2	**50%**
HIE	5	13	**38%**
Aberdeen	3	6	**50%**
Tayside	3	8	**38%**
West	18	40	**45%**
East	29	67	**43%**
Total	**59**	**136**	**43%**

* SE/HIE – Scottish Enterprise/Highlands and Islands Enterprise

Source: Glancey K, Grieg M and Harrison R T (2008) *The Venture Capital Market in Scotland – a Benchmark Analysis and Report: A Report to Scottish Enterprise*, Glasgow: Scottish Enterprise

Table 2: Value of SE/HIE* Investment relative to all investment by Geography, 2007			
Region	**SE/HIE Investment**	**All Investment**	**SE/HIE percent**
South	£100,000	£275,000	**36%**
HIE	£891,500	£5,741,680	**16%**
Aberdeen	£497,000	£4,833,938	**10%**
Tayside	£375,000	£1,353,968	**28%**
West	£5,898,986	£30,986,919	**19%**
East	£5,055,224	£61,643,992	**8%**
Total	**£12,817,710**	**£104,835,497**	**12%**

* SE/HIE – Scottish Enterprise/Highlands and Islands Enterprise

Source: Glancey K, Grieg M and Harrison R T (2008) *The Venture Capital Market in Scotland – a Benchmark Analysis and Report: A Report to Scottish Enterprise*, Glasgow: Scottish Enterprise

Table 3 Allocations* of Scottish Co-Investment Funds

SCF		
Allocation Range	**Number of Partners**	**% of Allocation**
£0 to £ 250,000	9	8.41%
£250,001 to £5000,000	5	11.64%
£500,001 to £1,000,000	1	3.69%
£1,000,001 to £2,000,000	3	25.97%
£2,000,001 to £3,000,000	2	27.82%
£3,000,001 to £4,000,000	1	22.47%
Grand Total	21	100.00%
SCFII (as of June 2009)		
Allocation Range	**Number of Partners**	**% of Allocation**
£0 to £ 250,000	4	1.14%
£250,001 to £5000,000	5	3.76%
£500,001 to £1,000,000	6	9.31%
£1,000,001 to £2,000,000	15	38.24%
£2,000,001 to £3,000,000	2	9.80%
£4,000,000 +	4	37.75%
Grand Total	36	100.00%

Note: Only "current" companies included in these figures i.e. trading as at 22/07/09

Note: SCF relates to funding provided under the 2000-2006 ERDF Programme; SCFII relates to funding provided under the 2007-2013 ERDF Programme. The last investment made under SCF was in November 2008

* On admittance to the scheme, partners are allocated SCF funding they can draw down into deals based on their projections of their investment activity; these allocations are reviewed every six months and may be adjusted based on actual investment performance

Table 4 Analysis of SCF Partners by Organisation Type

Type of Partner	Number of Partners	Number of Transactions	Number of Companies	Amount of SCF Investment	Size of Average SCF Investment
Angels Syndicate	18	209	99	£22,950,769	£109,812
Individual Angel	2	55	27	£5,044,220	£91,713
Corporate	8	44	31	£3,746,824	£85,155
Venture Capitalist	8	54	27	£9,740,579	£180,381
TOTAL	36	362	184*	£41,482,392	£114,592

Note*: Includes some double counting as some companies receive investment from more than one SCF partner

Table 5 Leverage of SCFI Investment

Type of Partner	Amount of SCF Investment	Partners' Investment	Other Private Investment	Other Public Investment	Total invested	Leverage (Ratio of SCF to total other investment)
Angels Syndicate	£22,950,769	£32,815,019	£12,918,320	£718,467	£69,402,576	1:2.02
Individual Angel	£5,044,220	£7,803,355	£5,788,732	£223,750	£18,860,058	1:2.74
Corporate	£3,764,824	£4,162,448	£2,883,090	£880,000	£11,672,362	1:2.10
Venture Capitalist	£9,740,579	£12,550,322	£11,662,363	£128,948	£34,082,213	1:2.50
Grand Total	**£41,482,393**	**£57,331,145**	**£33,252,505**	**£1,951,165**	**£134,017,208**	**1:2.23**

Table 6 SCF Investment by Year

	Number of transactions (companies)	SCF Investment £000
2003	17	2007
2004	30	4483
2005	51	7731
2006	46	8186
2007	47	7140
2008 (Jan-June)	29	3757
Total	220 (118)	33305

Source: Scottish Enterprise web site

Table 7 Size Profile of Investments

Deal Size	**SCF**	**% of Companies**	**SCFII**	**% of Companies**
1-50,000	3	3.09%	5	10.64%
50,001-100,000	6	6.19%	18	38.30%
100,001-200,000	26	26.80%	14	29.79%
200,001-300,000	12	12.37%	3	6.38%
300,001-400,000	8	8.25%	3	6.38%
400,001-500,000	17	17.53%	1	2.13%
500,000+	25	25.77%	3	6.38%
Grand Total	97		47	

Only "current" companies included in these figures i.e. trading as at 22/07/09

Table 8 Regional Distribution of SCF Investments by SE Office

SE Office	**Number of Companies**	**Value of Investments**	**Percentage of total Companies/ Valuation**
Highlands and Islands Enterprise	1	£224,000.00	1.03 / 0.63
Scottish Enterprise Aberdeen City & Shire	6	£1,776,374.08	6.19 / 4.96
Scottish Enterprise East Central Scotland	45	£17,042,250.68	46.39 / 47.58
Scottish Enterprise South of Scotland	1	£822,000.00	1.03 / 2.29
Scottish Enterprise Tayside	6	£2,029,521.40	6.19 / 5.67
Scottish Enterprise West Central Scotland	36	£13,231,187.86	37.11 / 36.94
SEN - High Growth Unit	2	£695,671.45	2.06 / 1.94
Grand Total (note 2)	97	£35,821,005.47	100.00 / 100.00
SCFII			
SE Office	**Number of Companies**	**Value of Investments**	**Percentage of total Valuation**
Scottish Enterprise Aberdeen City & Shire	2	£217,116.25	4.26 / 2.76
Scottish Enterprise East Central Scotland	21	£4,305,023.62	44.68 / 54.73
Scottish Enterprise Tayside	7	£553,760.85	14.89 / 7.04
Scottish Enterprise West Central Scotland	14	£2,319,916.76	29.79 / 29.49
SEN - High Growth Unit	3	£470,649.32	6.38 / 5.98
Grand Total	47	£7,866,466.80	100.00%
Note: This analysis excludes companies no longer trading			

Table 9 Performance of SCF v actual (final claims for 2000-2006 ERDF Programme

	Cumulative target to 31/03/08	Cumulative actual
No of new SMEs receiving investment	42	35
No of existing SMEs receiving investment	125	96
Total no of gross new jobs created	920	941
Increase in turnover of assisted SMEs[7]	£74.72m	£168.7m
Private sector leverage[8]	£25.25m	£44.95m

[7] Based on data on turnover figures to mid-2007 included in Table 8.1 of *Evaluation of ERDF Supported Venture Capital and Loan Funds and the Scottish Co-Investment Fund*, Scottish Executive 2008

[8] Data from Scottish Co-Investment Fund Annual Report for the year to 31 March 2008

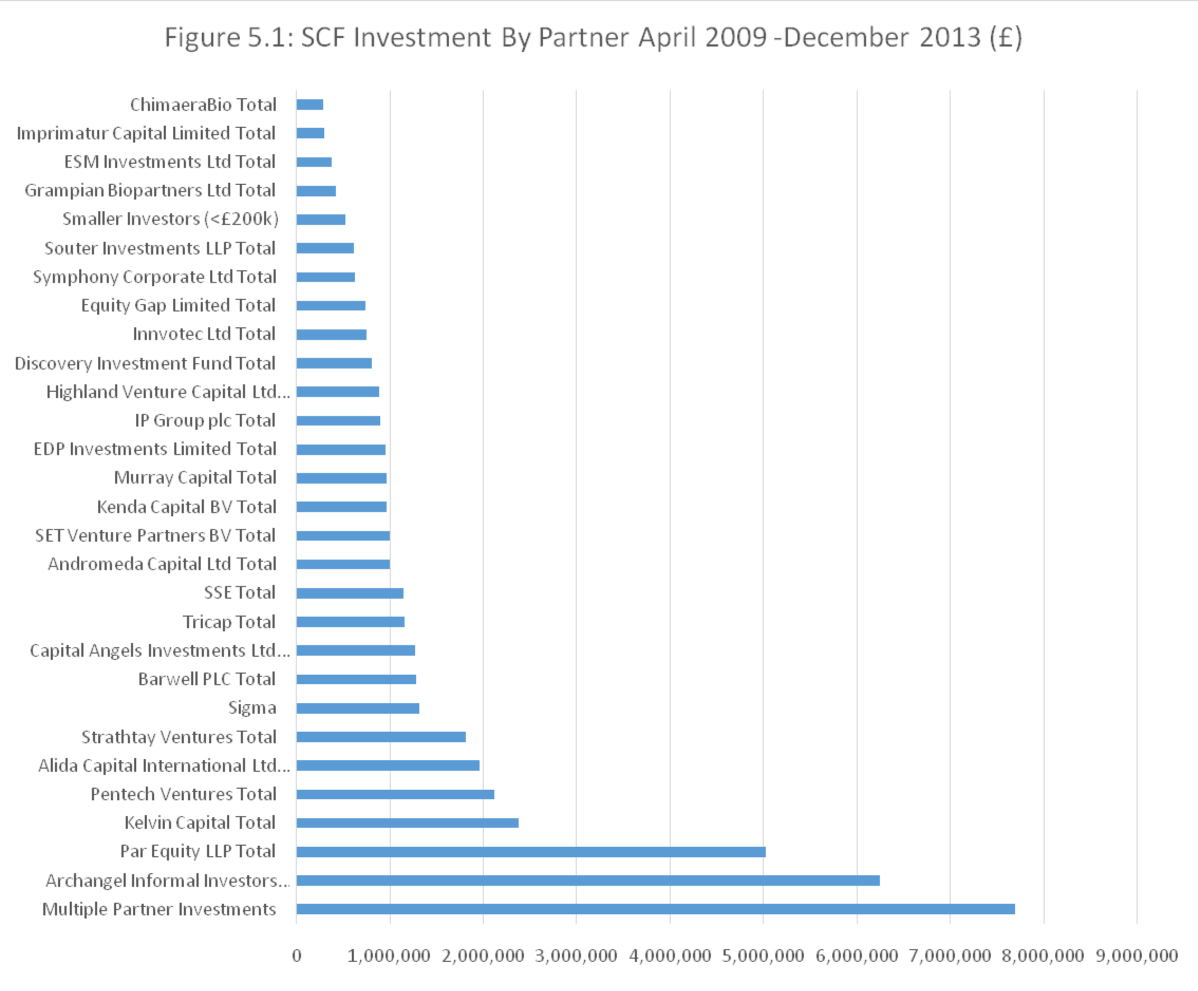
Figure 1 Scottish Enterprise Support for the Risk Capital Market in Scotland, 2009

	Transaction size	SE Participation Amount	Key Features
Scottish Seed Fund	Up to £500k	Up to £100k	Specifically for early stage deals, external investor usually required, debt and equity option.
Scottish Co-Investment Fund	£500k - £2m	£100k - £1m	Partners are vetted, the SCF automatically matches all qualifying investments from registered partners subject to eligibility.
Scottish Venture Fund	£2m - £10m	£500k - £2m	Partner agreements are informal, partners introduce deals to SE to be matched subject to diligence and negotiation. Syndicates can be arranged and new pa

Create, Grow & Retain Companies of Scale in Scotland

Source: *The strategic role and contribution of the risk capital market to the development of Scotland's economy* (SEBPC(09)1, 2009, Scottish Enterprise

Figure 2 SCF II Investment Activity by Partner Investor April 2009-December 2013



Source: Watson (2017, 30)