

Technology Enterprise Group Seminar – Summary Notes

Title: "More than money: The reality of seed stage venture capital and the growth of new technology ventures"

Speaker: Martin Rigby, Managing Director, ET Capital (www.etcapital.com)

Date: Thursday 4th November 2004

Time: 16:00 – 17:00

Venue: Seminar Room B, Institute for Manufacturing, University of Cambridge.

Martin’s presentation began with a positioning of venture capital within the financial services industry, as one of the ‘alternative asset classes’ that includes hedge funds and derivatives. The broad spectrum of equity investments (or purchasing of company shares) can be split into two categories: venture capital and private equity¹. The different needs and purposes of each are summarised below:

	Private equity	Venture capital
Requires:	<ul style="list-style-type: none"> – Predictable upside and limited downside – Cashflow to provide running yield and service finance – Identified liquidity event 	<ul style="list-style-type: none"> – Potential for highest possible upside – Clear potential for trade sale or flotation – Defensible market opportunity
Accepts:	<ul style="list-style-type: none"> – Limitation on upside 	<ul style="list-style-type: none"> – Potential for 100% downside loss
Suits:	<ul style="list-style-type: none"> – Cash generative businesses – Mature industries with stable markets and products 	<ul style="list-style-type: none"> – Businesses with new products or technology – Businesses with limited track record

The pressure that is now placed on venture capital funds was then highlighted, stressing the challenges on fund managers that include: the need to deliver strong cash to cash performance (measured through the fund’s internal rate of return, or IRR) – and hence the need to focus on the ‘liquidity event’ (trade sale, floatation, redemption) that converts the equity back into cash; shorter timescales demanded

¹ Confusingly, the term ‘private equity’ is also sometimes used to describe all equity investments that are not ‘public’ (i.e., investment into companies whose shares are floated on a public exchange).

between investment to liquidity event; and demands for increased transparency of portfolio performance.

For technology venture capitalists in the UK, these pressures are underpinned by overall poor performance as summarised below:

Private Equity/VC	2003	3 years	5 years	10 years
Non-technology	15.3%	5.7%	11.8%	15.6%
Technology	-18%	-24.4%	-10.3%	-6.5%

Source: BVCA Private Equity & Venture Capital Performance Measuring Survey 2003

On the positive side, there would seem to be a number of opportunities for UK venture capital investors: there are a number of high technology clusters around the UK (Oxford, Cambridge, London - based around UCL and Imperial, Edinburgh, Manchester) that are prolific sources of new innovation-based firms with great potential. Examples were given of Cambridge companies that have delivered real value to investors such as ARM, Element-14, Virata and Autonomy.

The problems for venture capital investors is that the UK:

- is a comparatively small market in a global perspective;
- has few larger, successful technology-based businesses than the USA and some European countries;
- is short of general management and marketing talent for technology based businesses;
- has a corporate culture slow to adopt innovation.

Taking a broader view and including all of the Europe, there are still challenges as Europe:

- is not homogenous – technically or linguistically;
- is expensive to penetrate and support;

But Europe does have some redeeming features. The example given was the decision taken to adopt the GSM/GPRS standard for mobile communications. This led to a faster uptake of mobile phones than in the US and led to rapid advances in technologies and services.

In contrast, the US is:

- the largest homogenous market for technology products and services – including information & computer technologies, healthcare and medicines, aerospace and media;
- the domicile of the majority of large technology-based companies, and;
- a rapid developer and adopter of new technology.

The view was put forward that UK/European businesses will fail unless they enter global markets (especially the US) from the start but that they must also have a credible market entry strategy to eliminate/minimise the risk of globalisation or trans-Atlantic transfer.

Attention was then turned to some of the common myths and half-truths relating to innovation in the UK:

- “UK industry doesn’t take innovation seriously” – in many cases, but also there are some exceptional innovation-based businesses (GSK, Rolls-Royce, etc.)
- “UK financial institutions are risk averse and don’t support innovative businesses, unlike European financial institutions, especially German banks” – research on Germany shows that German banks are, if anything, more risk averse than their UK counterparts².
- “US VCs are prepared to take many more risks than UK VCs” - perhaps, but this is because they are more reflective and can balance risk against real potential for value generation through putting a strong management team with an opportunity – and giving it full support. This is, in part, due to the top US VCs having managing partners with real operational experience, and hence are able to assess the potential for successful execution of a business plan.
- “US universities have massively strengthened their endowments through shareholding in technology spin-outs” – this is only true in a tiny minority of cases. The way in which universities such as Stanford have built strong endowments is through cultivating wealthy alumni.

The talk then turned to focusing on what is needed to support the successful growth of innovation based businesses in the UK. The key suggestions were summarized as follows:

- Develop a joined-up VC industry to allow the ‘charmed Silicon Valley process’³ to be emulated in the UK; i.e., leading law firm of Wilson Sonini Goodrich and Rosati (www.wsgr.com) push an idea they have heard about to top VC such as Kleiner Perkins Caulfield and Byers (www.kpcb.com) who take it seriously because of where it came from. When the time comes to seek a liquidity event, they can call upon top-flight investment bankers such as Morgan Stanley Dean Witter provide services needed to help ensure a successful exit. Contrast was made with the situation in Munich where public sector intervention led to a flurry of new firm creation activity, but largely without the ability to follow-through.

² Gill, D., T. H. W. Minshall and M. Rigby (2003). *Funding Technology: Germany - Better by design?*, Wardour Communications. Downloadable from www.ifm.eng.cam.ac.uk/ctm.

³ Stross, Randall E. (2002), *EBoys: The True Story of the Six Tall Men Who Backed EBay, Webvan and Other Billion-dollar Start-up*, Texere Publishing.

- We need to recruit better market-orientated general managers (why not draw upon UK strengths? We are world class in retail, media, distribution, financial services);
- Build effective globalisation methods, with acceptable levels of risk - learn from Israel where they were able to build global technology businesses from an unfavourable local base;
- Communicate better with government, pension funds and retail investors (VC can tell a great story – 10.7% p.a. to December 2002).

We also need to build a business development process which:

- works with UK centres of technology excellence to identify businesses with substantial, market-driven technology and adaptable founders;
- works with founders to complete the product-to-market process, utilising effective design and marketing;
- supplements/develops general management & marketing skills in those businesses;
- gets their products to global markets, including across the Atlantic, in an as risk free and effective a way as possible;
- invests in businesses progressively to minimise unnecessary management distraction.

Discussion then raised the following points:

- Role of executive head-hunters – VCs need to work really well with the best companies working in recruitment to ensure they can get the expertise they need into their portfolio companies. The example of the recruitment of Meg Whitman into eBay was given as an example of how the right CEO brought into a company at the right time can make a huge impact on the success of the business. It was also noted that the German firm PolyTechnos estimates that the average number of CEOs required between a company start-up and its floatation is three – emphasising the key role of good HR management for VCs.
- Large scale West Coast VCs such as Sequoia, Benchmark have sufficiently deep pockets that they are able to seed new ideas and follow-through with investment in subsequent rounds. This was contrasted with many European VCs. The case of CDT given as an example of a company that, it could be argued, has suffered from each round of investment being driven by new investors and subsequent changes to the business model.
- The role of angel investors in the UK was discussed, emphasising the key role that ‘smart’ angels can play in seeding successful technology ventures. The role of Venture Capital Trusts (VCTs) and changes to VCT legislation (modifications to tax relief on VCT-related investments) was not thought to be having a stimulating effect on the activities of angels.

- The role of Government: in response to a question raised on the public sector activities to build a stronger investment activities, comments were made on the role of the US Department of Defense Small Business Innovation Research (SBIR) programmes (www.acq.osd.mil/sadbu/sbir/) – and contrasting this to the role of Grants for R&D (formally SMART Awards - www.dti.gov.uk/r-d/) in the UK.
- The view was given by the speaker that we need a more professional VC industry, and it is really up to the VC industry itself to get more professional; there isn't much the Government can do about this.
- In response to a query as to whether there is a funding gap, the speakers view was that, generally, there isn't one. Good ideas with strong teams will get money; weak ideas, and ideas with weak management probably won't. That does not constitute a funding gap.
- The final comment was made that VCs and their portfolio companies need to have people on board that allow them to focus on the key activity of any business- effective execution of a business plan.

Websites and references related to the theme of this talk:

ET Capital – www.etcapital.com

Technology Enterprise Group – www.ifm.eng.cam.ac.uk/ctm/teg

British Venture Capital Association (BVCA) – www.bvca.co.uk

US National Venture Capital Association (NVCA) – www.nvca.org

US Small Business Innovation Research programs - www.acq.osd.mil/sadbu/sbir/

UK Grants for R&D – www.dti.gov.uk/r-d/

Summary of perceived funding gap in the UK – www.hm-treasury.gov.uk/media/959/03/adinvest359kb03.pdf

Library House Cambridge Cluster Report – www.libraryhouse.net/downloads/

Campbell, K. (2003). *Smarter ventures: A survivor's guide to venture capital through the new cycle*. London, FT Prentice Hall.

Stross, Randall E. (2002), *EBoys: The True Story of the Six Tall Men Who Backed EBay, Webvan and Other Billion-dollar Start-up*, Texere Publishing.

Gill, D., C. Martin, T. H. W. Minshall and M. Rigby (2000). *Funding Technology: Lessons from America*, Wardour Communications – download from www.ifm.eng.cam.ac.uk/ctm/teg

Gill, D., T. H. W. Minshall and M. Rigby (2002). *Funding Technology: Israel and the virtues of necessity*, Wardour Communications – download from www.ifm.eng.cam.ac.uk/ctm/teg

Gill, D., T. H. W. Minshall and M. Rigby (2003). *Funding Technology: Germany - Better by design?*, Wardour Communications – download from www.ifm.eng.cam.ac.uk/ctm/teg