SOME THOUGHTS ON TRENDS and MATURITY PATTERNS IN UK VENTURE CAPITAL, 1985-1993

Introduction

Venture capital is equity finance (the business risk-bearing class of capital) provided to unquoted businesses. Such investee firms can be started up, expanded, rescued, purchased as unquoted businesses, or become unquoted as a consequence of purchase using venture capital. Moreover, it can enable additional bank finance to be raised, usually of the traditional type (term, loans and overdrafts), which bears the credit risk but can form part of the purchase price. Equity is often said to be a relatively cheap source of funds in the early or critical stages of a business because dividends can be delayed or subdued until some future date. In the context of venture capital, this is usually related to achieving particular target levels of profit. The point at which the venture capital investor realises all or part of their claim is known as "exit". This can take several forms, including flotation on a stock market, selling to another company or "trade buyer", or selling to another venture capital investor.

In its purest form, venture capital is provided to businesses to enable them to develop a product or service, to commence trading, or to rescue them from failure. Such stages in a firm's life-cycle can be regarded as inherently risky and explains the use of equity and helps to define the term (ad) venture.

In its more generic form, venture capital is provided to businesses at different stages in the life cycle, where characteristics such as having established markets, proven profitability and experienced management are prevalent.[1] Equity here is used to allow (further) expansion, to replace an existing owner(s) or to replace an existing venture capital investor(s). This part of the venture capital industry has become dominated by management buyouts (and a variant known as a "buyin") which normally involves funds being provided to enable the existing operating management to acquire a product line or business (or to allow a group of managers from outside to buyin to the firm).

It might be expected that a sensible starting point to examine the ways in which the two sides of the industry operate, and interact with each other, would be the risk-return trade-off. With the inherently riskier investment of the "pure" type being compensated by correspondingly higher returns (in terms of both delayed but payable dividends and capital gains). Such that risk-preferred investors would congregate in the pure area, whereas the "generic" type would attract those funders wishing for lower risk, in return for lower rewards. And where trading at the margin would occur when individual venture capital investors wished to re balance the overall level of risk in their portfolios. Thereby creating a "secondary market" in venture capital investments with its own concerns about pricing, liquidity and confidence. However, as this paper will attempt to indicate, using straightforward year-on-year comparisons of the levels and distribution of investment activity data, that the UK venture capital industry[2] appears to behave as if the upside (return) is not necessarily positively related with the

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1 It is assumed that at whatever stage the firm happened to be, when the investment occurred, it would have the characteristics of good prospects, otherwise the finance would not be provided.

2 Along with those in USA and Continental Europe

downside (risk). As a consequence, it is not possible to describe the UK market as comprising the two polar cases (eg low risk, low return, and high risk, high return) with some trading or exchanging of investments in between the extremes. Rather, there is a dominate type of investment behaviour which is of the generic type (some of which is seen as lowish risk but highish return) with the pure type occupying something of a niche market position and appealing to particular investment decision makers.

Explanations for this structuring of the industry, and indications to the future, appear to be rooted in the following factors: access to deal flow and investment opportunities; the size of the investment that can be undertaken, both by value and as a percentage of the total equity provided; the alternative sources from which the funds are drawn by the investment managers; the experiences and philosophy of these managers; and certain structural parameters to do with mainstream corporate finance.

Section II will describe the main trends in the ventures capital investment activity since the mid-1980s; Section III will highlight the main changes in investing and funding behaviour and how these factors have influenced the dynamics of the structure of the venture capital industry; Section IV will go on to attempt to derive a set of criteria capable of assessing the maturity of the UK industry; and finally, in Section V, a view of the future of the venture capital market.[3]

[3] It should be noted that this paper does not consider the extent to which the UK venture capital market can be regarded as either an appropriate or successful response to the so-called "funding gap" in the small-to-medium-sized firms sector.

II Trends in Investment Activity

The period 1985-1993 has witnessed economic growth, recession and recovery and venture capital (VC) funding and investment behaviour reflects these distinct stages in the economic cycle. Having expanded rapidly during the years 1985, 86 and 87, the UK VC industry settled down to providing around £1.5 billion per annum to about 1500 businesses by the period 1988-90. The year 1991 saw a decline in this activity, with 1992 indicating a revival in funds in funds invested at £1.4 billion (see Table 1). Since 1989 the average value of each investment has been around £1 million, whilst the majority of the businesses since 1985 have been UK based. Although 1991 saw a slight decline in such deals, management buyouts and buyins continue to dominate the market, along with "independent" (see Table 3) venture capital organisations funded by UK and US pension funds and insurance companies. Consumer related firms operating from the South-East of England continue to be the most frequently supported industry sector and region. There has also occurred some "shakeout" within the fund managers area.

Using data drawn mainly from the annual reports published by the British Venture Capital Association (BVCA), and presented in the following tables, it is possible to examine the trends summarised above in more detail.

Table 1 Total Venture Capital Investment, 1985-1993

Year	No of Companies	Value £m	Average Value £m
1985	635	325	.51
1986	708	426	.60
1987	1298	1029	.79
1988	1527	1394	.91
1989	1569	1647	1.05
1990	1559	1394	.89
1991	1196	989	1.21
1992	1303	1434	1.10
1993	1198	1422	1.19

Source: British Venture Capital Association (BVCA)

As a specialist financed operation VC has grown from a handful of providers in the mid-1970s to some 115 by early 1993, as measured by membership of the BVCA. Between 1985 and 1993 the total amount invested by VC funds is over £10 billion. The peak year for funds invested was 1989 at £1.7 billion which coincided with the MBO boom of 1987-89. Nonetheless, the aggregate funds invested of £10 billion can be regarded as meaningful in terms of the industry becoming an established (and sustainable) source of funds for unquoted companies. Some VC fund managers take a very close interest in their investee companies and will provide management and industrial expertise to help them to get started and in times of difficulty (known as "hand-on" participation). Although the main attraction to financiers remains the prospect of earning a significant premium over quoted investments. The return on equity investments is usually calculated using the Internal Rate of Return measure, including dividend distributions and profits from asset disposals or the profits shown on a "fair" valuation of an investee company. Most venture capitalists set target rates of return of 30-40 percent on their portfolios, with variations dependent upon the stage at which they become involved.

II 1. **<u>Categories of Venture Capital</u>:** the venture capital industry divides its investment activities into the following main types or 'stages':

i) <u>Start-up</u>: financing provided to companies for the use in product development and initial marketing. Companies may be in the process of being set-up or may have been in business for a short time, but have not sold their product commercially. Where very small amounts of capital (usually defined as £25,000 or less) are needed to turn a good idea into a marketable product or service venture capitalists refer to this as '<u>seed capital</u>' or '<u>cornerstone financing</u>'.

ii) <u>Early stage</u>: financing provided to companies that have completed the product development phase and require additional funds to initiate commercial manufacturing and sales. They will not yet be generating profit.

iii) <u>Expansion</u>: capital provided for the growth and expansion of a company which is breaking-even or trading profitably. Funds may be used to increase production capacity, market or product development or to provide additional working capital. Included in this category is recovery or '<u>turnaround</u>' financing. This is supplied to companies in difficulties where the venture capitalist sees an opportunity to strengthen or change the management and improve financial performance. '<u>Re-financing</u>' a replacement of bank debt would also be part of this type of investment and can be a sign of either failure or success. If a company performs poorly it may need an extra injection of funds. Equally, if it does well, the management may decide to re-finance the business on terms more favourable to themselves with their original venture capitalists or a new team of financiers.

iv) <u>Management buy-outs and buy-ins</u>: under the former funds are provided to enable the existing operating management to acquire a product line or business. Under the latter funds are provided to enable a manager or group of managers from outside the company to buy-in to the company.

v) <u>Secondary purchase</u>: buying the existing shares of a company from another venture capitalist, or from another shareholder(s).

The following table (Table 2) gives a breakdown of the percentage of the total amount of financing accounted for by each of the above categories:

<u>Table 2 Venture Capital Investment by Financing Stage, 1986, 1989, 1991 and 1993</u>

<u>Stage</u>	**<u>% of Amount Invested</u>**				**<u>Average Size of Financing £m</u>**				
	1986	**1989**	**1991**	**1993**	**1986**	**1989**	**1991**	**1993**	
Start-up	15	6	4	3	.512	.486	.223	.280	
Early stage	8	9	2	3	.371	.375	.195	.308	
Expansion	27	23	34	25	.362	.674	.584	.472	*
Buy-out/buy-in	45	61	55	62	1.325	2.604	1.889	3.300	
Secondary Purchase	5	1	5	7	.725	.792	.414	.849	

* This excludes refinancing of bank debts which averaged £595,000 but this sub-category accounted for 1 per cent of the total amount invested.

Sources: BVCA, Venture Economics and 3i

The figures contained in Table 2 have prompted some observers to argue that the venture capital industry is not fulfilling the adventuresome function implied by its name. Not least because of the dominance of buy-outs and buy-ins in the amount invested but also because of the average size of such deals. Several factors exist to explain this trend, including:

i) The experience of the early funds which rapidly acquired rather ambitious portfolios of young high risk companies, many of whom went bust. This has produced a more risk-averse attitude within the venture capital industry;

ii) The growth of management buy-outs provided a ready supply of much less riskier opportunities for investment. Such companies tend to have established management teams, operate in mature industries with solid profits and cash flow, and this usually results in the time between buy-out and stock market flotation being relatively short. Hence, investors have a reasonable expectation of a rapid payback. Start-up companies by contrast, may be 5 or 7 years from exit; and

iii) Small companies, as potential recipients of investors' funds need to be extensively researched and may require assistance from the fund in managerial resources in its early stages of development. This is both time-consuming and expensive for the fund. As a consequence, the average size of tranches of investment has been rising steadily from around £100,000 to £750,000.

In other words, around 90 per cent of the total amount invested (expansion, excluding refinancing which could be regarded as "pure" VC plus Buyout and buyin) is of the generic type. This leaves about 10 percent in the pure VC market at an average of £500,000 per investment.

II 2 <u>Types of Venture Capital Organisation</u>:

The VC industry uses several different types of investment funds or vehicles. The three definitions given below denotes the type of organisation, not the type of venture fund manager. A number of venture capitalists manage more than one fund each, although under common management these funds may have different sources:

i) <u>Independents</u>: these can be either private or publicly listed firms, funds or investment trusts. They will have raised capital from more than one, primarily institutional source. This category includes 3i plc which is owned by the major clearing banks and the Bank of England. 3i has announced its intention to seek a listing on the London stock market when "the market conditions are right".

ii) <u>Captives</u>: these are specialist venture or development capital funds managed on behalf of a parent institution. They can be a wholly-owned subsidiary or division of the parent, usually a financial institution such as a bank or pension fund.

iii) Semi-Captives: these organisations not only manage independently raised funds but also invest funds on behalf of a parent.

The following table (Table 3) gives a breakdown of the amount invested by each of the main types of venture capital organisation.

Table 3 Venture Capital Investment of Type of Organisation, 1986, 1989, 1991,1992 and 1993

Organisation Type	**% of Amount Invested**				
	1986	**1989**	**1991**	**1992**	**1993**
Captive	44*	26	25	29	26
Independent	56	74	75	50	46
Semi-Captive**	-	-	-	21	28

* Prior to 1987 3i's investment activity was included under 'Captive Bank'.

** This represents a "new" type of VC organisation for which data has been collected since 1992

Source: BVCA

Table 3 shows that investment by organisational type is dominated by the independents, the largest of which is 3i plc. According to unpublished sources 3i accounts for about 30 per cent of the total amount of VC funds invested annually in the UK. The contribution from Captives has remained at around the same level since being separated from 3i in the presentation of the numbers by the BVCA. It is the creation of the new category, Semi-Captive organisation, that is noteworthy as a development of the UK industry. Such organisations raise funds from domestic and international capital markets, as well as receiving an allocation of assets from a parent. This trend towards the offering of such investment selection and management expertise to outside funders has not occurred suddenly, rather it reflects a growing realisation among captive fund owners of the benefits of such features as syndication and the sharing of investigation ("due diligence") costs. If the 1992 and 1993 numbers can be taken as indicative, then the trend for the future would seem to favour the semi-captive organisations. This implies a realignment which is most likely to be away from the independents, given the stability of the captives, and can be explained in terms of maturing. that is, as the industry develops and comes to rely increasingly upon the track record of a fund when allocating funds, either directly through the market or indirectly through the asset allocation process, the semi-captive may have seem to be stronger as measured by risk spread and the distribution of expected return. (This point will be discussed further in Section III).

II3 Funds Raised by Source:

1991 was the first year such information was reported. Table 4 indicates the amount raised in the form of new commitments to independent funds increased significantly (by nearly 40%) in 1993 from that raised in 1992. Although this amount of £347 million was slightly down on the 1991 figure of £368 million. Clearly pension funds continue to be dominant, but their contribution has dropped and now appears to be set in the 45-50% range. 1993 has witnessed a resurgence of interest by banks and continued string interest by insurance companies. Nonetheless, the decline in corporate and private individual investors is disappointing given the importance of independent funds as a source of VC investment (see Table 3) however, an active corporate venturing market so often regarded as characteristic of a fully-fledged VC industry (see later). It is however difficult to read too much into these numbers as the other side of the funding sowler equation, namely funds raised by the captive and semi-captive funds will be a function of the internal asset allocation of their funding institution(s) and as a result will be confidential and not reported.

Table 4 Independent Funds Raised by Source, 1991, 1992 and 1993

Source	**Amount Raised**			**% of Amount Raised**		
	1991 £m	**1992 £m**	**1993 £m**	**1991**	**1992**	**1993**
Banks	14	10	45	4	3	9
Pension Funds	251	157	232	68	45	48
Insurance Companies	34	72	106	10	21	22
Corporate Investors	20	50	37	5	15	8
Private Individuals	22	38	19	6	11	4
Government Agencies	1	5	3	0	1	1
Academic Institutions	6	1	21	2	0	4
Others	20	14	17	5	4	4
Total	**368**	**347**	**479**			

II4 Industry Sector Investment:

Consumer related businesses attracted the most venture capital investment, and this percentage has risen from 20 to over 30 between 1986 and 1993. Although the percentage of companies in this sector has remained reasonably stable, suggesting that the average size of each investment has been rising significantly. Table 5, produced below, indicates that the Industrial Products has benefited from the move away from the Computer-related sector.

Table 5 **Venture Capital Investment by Industry Sector, 1986 and 1993**

Sector	**% of Companies**		**% of Amount Invested**	
	1986	**1993**	**1986**	**1993**
Consumer Related	25	23	20	32
Computer Related	14	8	11	9
Electronics Related	8	7	8	5
Industrial Products	8	15	7	8
Med & Biotech	7	6	9	8
Communication	6	2	8	1
Energy	1	1	1	1
Transport	5	4	8	10
Construction	2	5	2	8
Financial Services	5	3	10	6
Other Services	14	16	13	8
Other Manufacturing	5	10	3	4

Source: BVCA

II5 Investment by Region:

The South East remains the dominant geographical region, although as Table 6 shows the degree of concentration, the terms of companies and amounts invested, has declined since 1986. Although it should be noted that as a percentage of the funds invested the South East has increased in importance in the post-recession cycle.

Table 6 **Venture Capital Investment by Industry Region, 1986 and 1993**

Region	**% of Companies**		**% of Amount Invested**	
	1986	**1993**	**1986**	**1993**
London & the South East	46	36	64	53
South West	9	5	5	3
East Anglia	7	3	5	4
West Midlands	6	7	3	6
East Midlands	4	6	3	4
Yorks & Humberside	3	9	3	3
North West	4	9	4	13
North	3	5	3	2
Scotland	9	14	7	10
Wales	9	4	3	1
Northern Ireland	1	2	<1	1

Source: BVCA

The figures for the South East are, however, likely to be influenced by investments in nation-wide groups which have their headquarters in London. Moreover, there is a greater density of companies in the South East than in any other region of the country. This can be expected to directly influence the number of investment opportunities across all categories or stages of venture capital involvement.

Outside the South East, most other regions have seen increased levels of investment although the North, East Anglia and Wales remain almost static.

In interpreting Table 6, it should be remembered that investments in each region are likely to be a function of the levels of business activity already present in the areas. This suggestion can be sustained by reference to the following table (Table 7) which indicates the number of venture-backed companies in relation to VAT registered-businesses.

Table 7 Investment by Region in Relation to Density of Businesses, 1992 and 1993

Region	Companies Invested in per 1,000 of Total VAT Registered Businesses	
	1992	1993
London and the South East	0.67	0.68
South West	0.47	0.36
East Anglia	0.85	0.54
West Midlands	0.77	0.51
East Midlands	0.55	0.57
Yorks and Humberside	0.82	0.77
North West	0.75	0.65
North	0.59	0.89
Scotland	0.83	1.28
Wales	0.47	0.59
Northern Ireland	0.47	1.39

Source: BVCA

Table 7 shows that particular regions, especially Yorkshire and the North, enjoyed a marginally higher level of venture capital investment than would be expected from the proportion of VAT registered businesses occurring within these regions. In the case of Scotland Table 7 suggests that in 1993 there was a significant amount of VC acting. However, these numbers need to be treated with care as they can be skewed by one or two large transactions. For example, East Anglia seems to have moved from marginally more to marginally less VC acting. In addition, Table 7 may indicate that certain areas, such s the South West and Northern Ireland are becoming very much less attractive to VC investors.

III Industry Structure Overview

The UK venture capital industry has had to adjust to several effects arising from recent economic conditions. Firstly, during difficult trading unquoted companies that lack the financial and managerial resource of larger, quoted ones are more likely to fail (although with an equal chance of dramatic falls in earnings). This has led to more time being spent on monitoring companies, on average a rise from 20 to 50 per cent of investors' time. Secondly, the decline in acquisitions activity has meant fewer buyers for investee companies so that venture capitalists have had to hold their investments longer leading to lower annual rates of return. Thirdly, a further shift towards backing larger, established companies but with a reduced emphasis upon buy-out funding. Larger (more than £100m) buy-outs of publicly-quoted companies may be deals of the past but small, conservatively financed (£1-25m) ones are likely to remain significant, as do fresh injections of equity into heavily-geared companies (sometimes known as 'second-round' or 'follow-on' financing). These changes have prompted many practitioners to describe the industry as "mature" and as with any industry entering this phase there must be a downward adjustment to expectation about returns. Equally, there are those that persist in referring to the industry as "young and cyclical". Whichever view is accepted there is evidence of: a narrowing of the focus of the UK venture capital industry; an increasing casualty rate among early stage players; and poor performance by peripheral funds for which venture capital is not a mainstream activity.

Venture Capital practitioners (that is, those that raise funds and make decisions about which businesses in which to invest) have, therefore, experienced relatively dramatic shifts in overall market conditions. From being seen as peripheral to mainstream corporate finance in the early-to-mid 1980s, to enjoying rapid expansion in the late 1980s, followed by a sharp decline in activity in the early 1990s. Such practitioners are now having to manage recovery conditions in which there appears little shortage of propositions worth backing but where the poor returns associated with the economic downturn have made both existing and potential backers (institutions and markets) more critical of accepted behaviour and, as a consequence, require more or different persuasion than previously before turning on the flown funds to earlier levels.[4]

Such changes are underway and include the following:

i) a search for a more rigorous set of guidelines by which to value individual investments held in particular portfolios, and to be able to do so throughout the life of the investment from initial stake to a point immediately before exit. This would reduce the degree of freedom currently held by fund managers to off set bad performances with flattering differences in valuation as between entry and exit;

ii) to bring forward the development of performance measures which will allow investors/backers to compare the results of the funds in which they are invested and to monitor the performance of their own in-house managers. Given that many

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4 Although it is not clear what the alternative uses of such capital would be, given that the bank backed funds are unlikely to repeat the disastrous over-expansion of their industrial loan books, and when the pension funds have asset allocation problems caused by depressed bond market condition.

of the larger backers of venture funds invest in several funds, of possibly varying vintages, and have teams of quoted investment managers;

iii) to encourage, rather than inhibit, the ways in which venture managers raise money. The traditional ten-year relationship is under scrutiny by institutional backers which has already generated some innovative structures; and

iv) a rapidly developing secondary market in venture portfolios (rather than individual investments as suggested earlier). Such that, if managers fail to raise "new" money they may resort to recycling existing ones.

Changed market conditions, shifts in the sentiment of institutional backers and the above changes are likely to lead to some industry "shake-out". As a result, a slightly different venture capital industry structure may emerge, comprising:

i) two divisions with a large "super league" made up of venture funds backed by large institutions but not necessarily where every large intermediary would be represented, and a smaller league comprising niche players based on venture capital teams with a reputation for investing in specialised businesses (for example, healthcare). The expectation would be that the larger groups could introduce deals to the specialist players because of the requirement for particular expertise; and

ii) as a result of i) above the UK venture capital industry would retain its diverse nature and could lead to a wider regional spread of investment activity through the extension of regional "networks" and the raising of funds locally. For example, smaller investments, unattractive to the larger houses, are being taken over by small, local venture firms and groups of private investors or 'business angels'. These local venture capitalists normally have the financial backing of the local authority or its pension fund or organisations such as enterprise agencies and the Local Enterprise Companies and Training and Enterprise Companies. Business angels, usually retired executives or entrepreneurs, who have sold their business, can provide not only finance to small companies but give them the benefit of their experience or expertise, or both.

During the early development of the UK venture capital market many practices were imported from the USA, including management fee levels. Typically, these have been set at the rate of 2-2 1/2 per cent of the funds invested. With poorer returns and confidence still lacking, especially by the substantial funders, it is now clearly recognised that such management fee levels provide an incentive for venture managers to increase the fund, rather than to maximise the value of the investments upon which they earn a share of the profit. It is suggested that such an arrangement has had the effect of venture managers becoming more concerned with seeking "new" money and setting-up new funds, instead of managing the ventures. As a result, fund-backers have become sophisticated in structuring deals with managers in an attempt to re-establish an incentive to improve returns. For example, withdrawal of funds on demand, "rolling" funds not "closed-ended" ones, and choices for backers over investment activity.

Investors have also moved away from ten-year partnership deals towards venture capital companies which would have an unlimited life. This has the virtue of releasing the venture managers from the artificial constraints of a ten-year deadline but could eliminate any pressure on them to realise the investments. In other words, by reconstructing their relationship with venture managers in order to improve the potential upside (optimum disposal time) fund-backers could be in danger of creating moribund funds where managers sit on the investment, drawing, albeit reduced annual fees.

One of the reasons usually given for the relatively high US venture management fees is the significant number of start-up deals undertaken. In terms of the percentage of the total, start-ups account for between 25 and 30 per cent of US venture activity. Such deals usually take longer to find backers, require more investigation, and are more likely to require "hands-on" venture management thereby justifying high fee levels. By comparison, UK start-up account for about 15 per cent of the deals done, and around 6 per cent by value (see Table 2). The latter number has remained at this level since 1991 but is significantly down from the 23 per cent in 1986. This begs the question about the future of "pure" venture capital to the UK.

Despite the shift towards larger deals, and with established businesses, there still exists a successful development capital sector. However, it is recognised that there is something of an early-stage and seed corn 'gap'. As a result, it has been argued that there is the need for cornerstone investment funds designed specifically to boost the supply of funds to younger more innovative companies. It has also been recognised that there is a duplication in the assessment of proposals, so that syndication tends to be on a purely financial basis and does not involve co-investors sharing other areas of expertise. This suggests that venture capitalists should be more willing to compare their portfolios and put together companies which might have a shaky future on their own, but put together they may constitute a potentially rewarding operation. Interestingly, recession has not only meant deals being more reasonably priced but has provided an additional impetus for syndication and alliances. The increased effort now required to bring together a good management team, finance and, sometimes, a corporate partner has provided greater opportunity for risk sharing. It has also had the effect of increasing the trend towards so-called 'bought deals'. This refers to the joint underwriting of large (more than £15m) and medium-sized deals.

Overall therefore, UK venture capital fund managers can be regarded as "seasoned", as they have experienced a full-turn of the economic cycle, and are witnessing the restructuring of the industry as well as changing customs and practices. The extent to which such factors constitute a mature market is the focus for the next section.

IV Maturity Criteria

It could be argued that a move away from start-up is not only a reflection of a returns-driven market restructuring but also a sign that the UK venture capital industry is evolving as a function of domestic attitudes and institutions. In other words, UK practitioners have recognised that neither the "portfolio" approach to accommodating high-risk start-ups, alongside medium and low risk expansion and buyouts, nor a highly selective approach of trying through investigation to "cherry-pick" (that is, picking winners) have paid off. Nor has it proved possible to finance the odd start-up deal within a later stage portfolio. Dealing with start-ups is, it appears, so different from providing large amounts of development capital or funding buyouts that many venture capital groups have abandoned early stage deals altogether. In the UK context, therefore, start-ups are not significant and when they do occur they are not of the "black box" variety, rather they involve experienced managers with a good idea and some acquisitions already identified. As such, they will form part of the niche player part of the industry.

In addition to the uncertainty regarding start-ups there are a number of other characteristics which can be seen as associated with the UK market moving to maturity:

i) standardisation of portfolio valuation and performance measures providing previously unachieved degrees of transparency of operation;

ii) structuring of deals and funds to reinforce i) above and to allow for designs that reduce the agency cost associated with backers and their relationship with fund managers;

iii) increased transparency and more effective monitoring has led to a more active secondary market but where this is at the portfolio and fund management levels, rather than involving individual investments; and

iv) relationship with mainstream corporate finance with some banks indicating that venture capital is not regarded as central to their activities. It is unlikely that banks collectively will pullout altogether. Not least because it provides a means of structuring debt deals involving equity and not in a uniform way.

V. The Future

The reforms now taking place, and described briefly in this paper, should lead to a more responsive and cost-effective industry by the late 1990s. This implies a "shake-out" resulting in a core group of up to, say, six "broad brush" players, alongside several niche funds. The pressure will be concentrated upon those funds that have not performed well such that they will find it increasingly difficult to raise "new" money and could find themselves taken over by other managers with superior track records (a process known as "cannibalism"). Moreover, funds that have shown themselves unable to manage "difficult" portfolios will be excluded from the increased use of syndication.

A possibly smaller, probably more profitable, but almost inevitably less diverse UK VC industry is envisaged for the 1990s. Such a prediction could be regarded as inconsistent with a fully matured industry. However, in the absence of a steady state, a pattern of maturity could be claimed to have been established. Based on seasoned fund managers and their backers there is now agreement, and a convergence of agenda. For example, the shared goal of applying techniques capable of comparing performances as between funds and standardised valuation procedures. This is a type of received wisdom which is representative of a maturing market.

There remains, however, at least two areas of uncertainty in the still evolving but maturing UK VC market. The first is the contribution made by pure VC and the commitment to providing start-up funding. The second is the likelihood of additional sources of finance beyond the banks, life offices and pension funds. If the UK continues to follow the development patterns observed in the US (which it has approximated with the notable exception of a lower activity rate in start-up) then "Corporate Venturing" is the missing feature of the UK scene. This occurs when a large company takes a small equity stake or establishes a joint venture with a smaller business to benefit from the smaller firm's specialist expertise or idea. The large firm can provide finance, management back-up and distribution outlets which would not be available to the smaller partner. The small firm brings its innovative skills and allows an intimate view of the new products and technologies it is developing. Corporate venturing links can lead to the bigger partner acquiring the smaller.

An alternative to the corporate sector as a potential additional source of funds is the much delayed (since Spring 1992) but still promised stock market flotation of 3i as an "approved" (able to sell shares directly to the public through a prospectus issue) investment trust company.. Although 3i prefers to be called a "development", rather than a venture, capital house it remains the single most important provider of small amounts of equity, as well as holding the largest portfolio of unquoted investments. It is also experimenting with initiatives to cut the cost of small investments and to involve local business support agencies in selecting firms to back. This can be interpreted as confirming 3i's commitment to this part of the VC market. 3i should also benefit from being released from the asset allocation constraint resulting from its present bank owners. There are concerns, however, about the change of 3i's ownership. Given its dominance to the VC market, once other institutions can acquire shares in the 3i portfolio they will channel all of their VC investment through 3i, thereby eliminating the smaller venture funds. It is also likely that as a quoted plc, 3i will need to deliver attractive and stable dividends which may make it reassess its risk-taking attitude. Such a short-term view may be reinforced because of the adoption of uniform valuation and performance measures.

This paper has attempted a description of the current picture of the UK VC market as it has emerged since 1985. Although aspects of its nature, structure and operation are clear, others remain subject to change. The emphasis (and by implication the skills of venture managers) have become centred upon financing different stages of the ownership of business (for example, public to private than back to public) with suitable rates of return at each change. To this extent, the UK VC market can be viewed as a sub-set of mainstream corporate finance which (rightly) has as its focus financial (re) engineering, not the provision of appropriate capital structures for firms at different stages of the life-cycle.

References

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