BVCA Chairman's Speech
BBAA conference
12 June 2006
Royal Bank of Scotland Conference Centre

1. Introduction

I am pleased to be here and to have been given the opportunity to speak to you about the common interests and ambitions that, as investors and entrepreneurs, we share.

The British Venture Capital Association represents the overwhelming majority of UK based private equity and venture capital firms and has over 350 members.

The UK Private Equity market is the largest and most dynamic in Europe, accounting for some 52% of the European market.

UK businesses that are or have been private equity backed now employ some three million people in the UK – about 1/5 of the private sector workforce.

This industry is invested in every sector of the economy across all regions of the country.

That means the economic and social impact of this successful and dynamic industry is profound and continues to grow.

The strength and stability of the UK market was reaffirmed again in 2005, with investment activity levels registering a third consecutive year of growth.

Our recently published Report on Investment Activity showed that in 2005 investment by UK private equity firms increased by 21% to £11.7bn..

The industry also achieved a record-breaking year in terms of fundraising, attracting £29.4bn of new capital from its investors, with strong support from both local and overseas institutions.

The BVCA membership comprises pretty much all of the UK private equity industry. This ranges from small venture firms to some of the largest buyout firms in the world who operate with offices in London.

This is a very broad constituency and of course many of the transactions undertaken by the large buyout firms are the ones that have the highest profile and public awareness.

However, we must remember that although this part of our membership is active and high profile, they are only part of what BVCA members do.

2. The Significance of the Early Stage Market

For example, last year our members backed more than 1,300 UK businesses and almost 80% of these were made for less than £2m.

The message from this is clear; the smaller, entrepreneurial end of the market is crucial to our continued vibrancy and success.

The BVCA's latest Report on Investment Activity shows that investment in start up businesses last year increased by a robust 67% to £160m.

The number of early stage businesses receiving funding rose by 8% to almost 500 in 2005, representing almost 40% of all companies backed by the industry during the year.

3. Government Support for the Industry

The industry has enjoyed strong government support, particularly over the past ten years.

The Treasury is well aware of the economic contribution made by the UK private equity industry. UK SMEs employ over half our private sector workforce and contribute over £1bn of turnover per annum.

The Government's support for SMEs can be traced back to March 2000, when the European Heads of Government and State committed to the Lisbon Agenda.

The Lisbon Agenda is a ten-year strategy of reform for Europe's labour, capital and product markets, which aims to make Europe, *'the most dynamic and competitive knowledge-based economy in the world,'* by 2010.

The UK Government's emphasis on 'stimulating innovation' and fostering a 'culture of enterprise' form a core element in its strategy for delivering on this target.

The Government's commissioning of 'Bridging the Finance Gap' consultation is another key milestone in its campaign to create an enterprise culture.

The consultation sought to better understand issues surrounding the supply of capital to the UK's smaller, high-growth businesses. It evaluated the scope of the mooted 'finance gap', its underlying causes and possible ways to stimulate investment.

The Government launched the Enterprise Capital Funds on the back of this consultation process, committing £100m of public sector funding, to be invested alongside capital from private sector investors. The funds target businesses seeking between £250,000 and £2m of equity.

The first four ECFs have now been announced, some of which involve partnerships between business angels and venture capital fund managers – a positive example of how our two communities are beginning to work together more closely.

Channelling angel investment through institutional fund structures such as the ECFs is a welcome development, perhaps representing a more effective structure than the existing tax-based schemes such as the Enterprise Investment Scheme, which limits participants to investment in ordinary shares. These structures can be difficult to integrate into subsequent institutional funding rounds.

4. The BVCA in Dialogue With Government

The BVCA is continually engaged in dialogue with the Government and has been particularly active in relation to the 'equity gap' issue.

We contributed to the 'Bridging the Finance Gap' consultation and have played an instrumental role in the creation and ongoing support of the VCT industry.

The BVCA is committed to maintaining a favourable environment for investors in and managers of entrepreneurial, growth businesses, encouraging a favourable tax regime and guarding against over-regulation; a goal that I am sure is shared by the business angel community.

5. The Value of Business Angels

The value of individuals who can bring more than just capital to private equity backed businesses is important for all types of private equity transactions.

This is particularly the case with smaller and early stage companies, where the value the business angel community can bring is considerable.

Angel investors are a key source of finance to start-ups, as many institutional venture capital funds have been unable to realise the necessary economies of scale to focus exclusively on this market segment.

For example, a £20m venture capital fund with two or three full time investment executives committing £500,000 per company would amass a 40-strong portfolio – a significant management challenge.

These metrics may prohibit VCs from providing the levels of strategic and commercial input that are central to the private equity model.

Business Angels, on the other hand, are able to provide ‘smart capital’ to young businesses; their commercial and strategic expertise, not to mention their time and enthusiasm, are as valuable as their financial contribution.

Business angels, therefore, are vital not only as a source of capital for start-up businesses, but of management time.

6. The Relationship Between Business Angels and VC Communities

The fact that business angels tend to focus on seed and start up funding of high-growth businesses means that the need to raise further rounds of capital is generally a given.

Therefore, a close working relationship between angels and VCs is vital in ensuring a seamless supply of capital to these businesses.

Nevertheless, commentators often raise the issue of a ‘disconnect’ between business angel and venture capital communities, suggesting that there is a need for the BBAA and the BVCA to do more to encourage communication between our respective membership bases.

And what are the possible causes of this perceived disconnect?

Firstly, commentators have pointed to something of a cultural and motivational asymmetry between angels and VCs.

While most angels do have economic motivations, emotional attachment and general enthusiasm for the process of building a business often feature higher up their list.

This can sometimes be in stark contrast to the harsh reality of the VC model, which, first and foremost, seeks to optimise return on investment.

Secondly, a VC will have a keen eye on corporate governance, putting in place formal structures and processes, including a visible and credible management team, regular board meetings, rigorous financial reporting and performance monitoring.

This more formal approach can fundamentally change the dynamics of a seed investor’s role and their relationship with a company’s founders.

A seed investor may find themselves having to take more of a back seat when a VC comes aboard, having previously been closely involved in a company’s development.

Thirdly, deal structures and valuations have proved to be perennial sticking point for business angels and VCs.

Due to the tax breaks available through the Enterprise Investment Scheme, business angels tend to invest in the ordinary share capital of a business, which can lead to dilution when a VC comes aboard.

This is exacerbated in situations where the incumbent angel investors and the incoming VCs disagree on valuation, which is not an uncommon event.

Finally, the difficulty faced by business angels in achieving an exit also remains a key issue.

Whether a business angel exits or stays for the ride when a significant round of later stage funding is secured is often not a matter for debate.

Angels are often locked into their investments for a significant horizon, potentially facing dilution by later stage investors.

7. Working together

Building an effective working relationship between business angels and venture capital investors is going to require effective communication.

Business angels need to better understand the VC model and ultimately learn from it, while VCs need acknowledge and reflect the valuable contribution that business angels make to seed and start-up businesses.

The BBAA has joined the BVCA in placing education firmly on top of its agenda.

The BVCA's Education Commission recently sponsored the 'Enterprise 2005' report, which is the UK's first major report on enterprise culture within secondary and tertiary level education; we also offer a range of training programmes to private equity professionals.

We are keen to explore ways that the BVCA and the BBAA can work more closely together to better represent the joint interests of our members to those that develop policy in this area.

The BVCA's close contact with Government has resulted in the development of a constructive relationship that the business angel community can share the benefits of.

It is important that our communities present a united front in tackling key tax and regulatory issues and in working with the Government to deliver against its policy objectives for the SME market.

The BBAA and the BVCA are already in dialogue with a view to building bridges between our respective membership bases.

Indeed, on the back of the BVCA's *'Creating Success from University Spin-Outs,'* report, the BBAA and the BVCA are working together to create a forum for entrepreneurs, business angels and University Technology Transfer Officers and will be co-hosting a conference for delegates from these stakeholders later in the year.

Other positive developments include the appointment of Quester's Simon Acland to the BBAA Board.

Simon is a member of the BVCA's Technology Committee and will form another valuable conduit between our two organisations, exploring possible synergies and opportunities to work together.

At the next BBAA Conference in 2007 I am very hopeful that we will be able to report real progress and tangible results in our common aim of forging a seamless supply of capital for young, entrepreneurial and innovative companies, which are the lifeblood of a dynamic UK economy.

Thank You

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