TIME TO TAKE A DIFFERENT APPROACH

IAN BURNS OF SMITH AND WILLIAMSON EXPLORES THE CHALLENGES FACING UK VENTURE CAPITALIST INVESTORS AND WONDERS WHAT SURPRISES ARE IN STORE FOR THE VC MARKET IN 2003 .

Venture capital (VC) has traditionally been an important source of funds for start-ups, management buyouts and businesses undergoing restructuring. However, in the face of difficult market conditions, there is evidence both that treasurers, particularly in smaller companies, are turning to alternative sources of finance and that VC investors are losing faith in profitable exit opportunities. This article looks at some of the challenges currently facing VC investors in the UK and at the prospects for the VC market in 2003.

A DIFFICULT MARKET. Today's UK venture capitalists are becoming increasingly worried as they are forced to cope with:

- new investment levels which have halved over the last year;
- declining numbers of exits; and
- problems in raising funds, leading in some cases to returns of capital.

According to recent research by Ernst & Young and VentureOne, in the first half of 2002, European venture capitalists made investments in 53% less companies than in the comparable period in 2001, which itself represented a lower figure than the previous year. Indeed, in the UK, only 44 investments were identified in the quarter to June 2002, involving monetary investment levels of only 13% of the £1.6bn invested in the second quarter of 2000.

According to the latest British Venture Capital Association (BVCA) statistics, total numbers of UK divestments (excluding what is quaintly defined as 'divestments by way of write-off') increased in 2001 by 30%. This is, however, all the result of increases in underlying portfolio numbers, and historically low level of divestments in 2000. In fact, with one exception, the number of divestments as a percentage of portfolio volumes have declined steadily over each of the past five years.

Despite record UK fundraising in 2001, according to Initiative Europe, the number of new funds closed in the year actually fell. Worse, however, in the venture capitalist's eyes, the industry has consistently over the past five years raised more funds than it has invested; as a result, fund investors are increasingly jumpy about realisations and a number of funds have had to resort to the 'nuclear option' of returning their capital.

SO WHAT HAS LED TO THIS TRIPLE-WHAMMY?

SUPPLY-SIDE CONSIDERATIONS. Declining deal flow does not appear to be the result of any dramatic changes in the terms of reported investments: the research available seems to suggest that gearing levels (debt as a percentage of total transaction cost) have remained relatively steady at about 60%, with entry P/Es similarly stable at around x9-10.

But there is evidence to suggest that many transactions which previously would have formed the core of VC fund investments are now using alternative forms of finance, especially at the smaller end. In particular, the new aggression of the acquisition finance units of the clearing banks, together with the more creative use of vendor deferral and angel finance, is making its effect felt.

Finally, there is probably something in the argument that the position at June 2002 represents a low point in the micro-cycle, which has been significantly affected by the impact of the emptying of deal pipelines after 11 September and the continuing expectation gap reflecting the different speed with which venture capitalists on the one hand and providers on the other have lowered their expectations of what constitutes a realistic price.

DEEPER CURRENTS. In my opinion, however, these admittedly important supply-side factors have merely accentuated the impact of the undertow of a more sinister deeper current, affecting the venture capitalist's confidence that he or she will make a premium return on their investments. This is, in turn, the product of two factors:

- the economic environment, and
- the likelihood of profitable exits.

The impact of current economic turbulence – including the continuing backwash from the bursting of the technology boom, the sectoral impact of 11 September (on leisure, aerospace and the like) and the long-term structural problems of exchange rate-dependent

UK businesses, such as manufacturing – is undoubtedly important. It has, however, been widely commented on, and I will not expand on this here.

The malign effect of the current exit crisis is more pervasive. As well as directly reducing realised profits (as the old VC adage goes: "You don't make money by getting into investments, you make it by getting out"), the increasing time spent today by VC executives in "grooming their investments for exit" is taking the focus away from new investment.

It is also leading to portfolio indigestion, with consequent potential difficulties in trying to raise further funds. A small extension of timescales to realisation can make a big difference in IRR – still the benchmark of past performance when seeking to raise the next fund – and therefore published track record.

Exits are therefore critical, not only to venture capital returns, but also to deal flow and fund-raising ability. So what has caused them to dry up?

THE DROUGHT

Let's look at what has been happening to the various traditional sources of VC exits:

- **Flotations.** According to the BVCA, flotations of venture-backed companies have fallen from 44 in 2000 to 14 in 2001, with the prognosis even worse for 2002 because the IPO door remains resolutely shut.

- **Trade sales are down too.** Buy and build strategies are no longer flavour of the month in the quoted market, where both corporate executives and fund managers are becoming increasingly cautious, and organic growth is enjoying a renaissance.

- **The disappearance of the trade buyer has been exacerbated by sectoral and pricing considerations.** Neither the quoted TMT sector, nor the small cap non-technology sector – for many years the most fertile ground for VC exits – nowadays have the financial strength or stock market ratings to contemplate ambitious acquisition programmes.

- **Secondary buyouts** – or purchases by other funds – are talked about widely in the industry, but the BVCA recorded only 27 secondary buyouts in total in 2001, an increase in only seven over the previous year. Could this be an illustration of the famous venture capital scepticism – the "if John (or Jack or Susan) is selling, should I be buying?" syndrome.

SO WHEN WILL IT ALL END?

Venture capitalists are nothing if not an optimistic bunch, and there are no shortage of VCs and industry commentators predicting that things will pick up soon – witness the recent Cinven survey citing the second half of 2002 as the predicted turnaround point. Unfortunately, we have been hearing the same message from various sources within the industry for more than 18 months now. So what are the real prospects for recovery and, in particular, what are the prospects for exits?

Here, I confess, it is easier to identify factors that can be expected to revive investment rather than exits:

- the expectation gap will eventually close;
- public-to-privates will become the only viable alternative for a number of smaller quoted companies; and
- VC money as an alternative to rights issue or pre-IPO funding will see a resurgence.

Potential shots in the arm for the exit process are more difficult to see. There are, however, some long-term trends which I believe will help the industry here:

- **Secondary buyouts** (or refinancings by management) will continue to increase – albeit slowly – helped by the increase in the appetite of the banks for debt in these kinds of business, as noted above.
- **Buy and build** is not yet quite dead among venture-backed companies, and can be expected to revive quicker than in the rest of the market, holding out the hope of exits for investment companies of other funds.
- **The search for long-term equity investors** – the companies that the venture capitalists are currently finding it most difficult to sell are their solid, cash-generating investments with limited growth prospects. In the old days, a number of funds, notably 3i, were prepared to invest in this type of company on a long-term or even permanent basis; a phenomenon which has all but disappeared in these IRR/exit-driven times. Things are, however, starting to change, with HBOS Integrated Finance leading the way, and a number of other banks now starting to offer packages of long-term debt and equity to buy out the not-so-sexy bits of VC portfolios. It will not be long I believe before we see some dedicated independent equity funds set up to do the same.
- These trends will be aided by the imperative for the venture capitalists to clean up their portfolios, to halt the vicious circle described above.

The major engine of growth for VC exits, however, will have to come from a pick up in the capital markets. This will be the only way to bring back the trade buyers, still by far the most important source of VC exits. This will require an increase in investor confidence, and, in my view, will be most likely to be driven by a revival in the IPO market – which itself can be expected to have a directly beneficial impact on private equity returns, bearing in mind the fact that 34% of all IPOs since 1992 have come from venture-backed businesses. I would expect this would happen in the way that the industry recovered from its last recession, in 1993, which was led by a number of major IPOs, whose success trickled down into smaller company IPOs and increased trade buyer activity. There is no shortage of first-rate large companies currently sitting in VC portfolios waiting for the right market conditions to float and get the process going.

The big question, of course, is when? As the man said: "If I knew the answer to that, I would be rich." Venture capitalists can at least in the meantime console themselves with the thought that, when the upturn does come, their current enforced preoccupation with monitoring, portfolio management, and adding value to their companies will not have been in vain, and that they will in the future be able to offer the real cradle-to-grave service to which in many cases they previously only had to pay lip service.

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