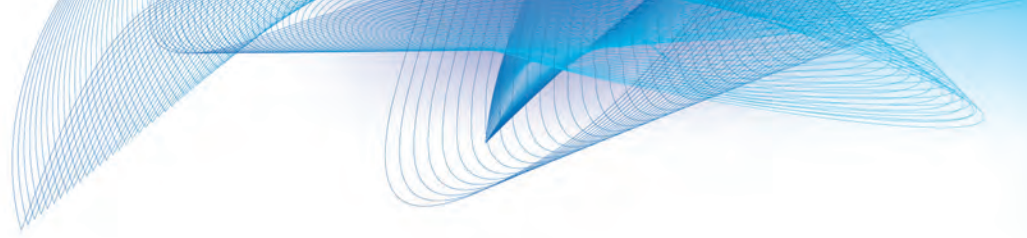


# Scottish Investment Bank

2010/11 Annual Review





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## Foreword from Gerard Kelly

Scottish Enterprise (SE) has had a major impact on Scotland's private sector early stage equity market since the introduction of its investment team in April 2003. With close to £130 million being invested from our equity schemes in the last eight years, leveraging a further £292 million of capital from private sector partners into many of Scotland's high growth early stage companies, we are now seeing meaningful commercial and economic returns for the Scottish economy. A key factor in our ability to support these companies has been our success in securing European Regional Development Funding (ERDF) over the last eight years.

The recession of the past three years has, however, created profound challenges for many companies in accessing capital beyond the early stage equity market. In response to these broader funding challenges, the Scottish Government and SE rebranded SE's investment team as the Scottish Investment Bank in December 2010 and expanded its remit to supporting the development of Scotland's private sector SME funding market to ensure that both early stage and established companies with growth and export potential have adequate access to growth capital. These are the companies identified in the Government Economic Strategy as having the greatest potential to contribute to economic recovery.

Reflecting this broader remit, the Scottish Investment Bank's first new initiative, the Scottish Loan Fund was launched in February 2011 just two months after the Scottish Investment Bank opened for business. The Scottish Loan Fund specifically targets an identified market gap for established and viable growth and export potential SMEs, that are unable to access growth capital to realise their ambitions.

The Scottish Loan Fund was designed and established by Scottish Investment Bank but operates as a private sector fund, independently managed by Maven Capital Partners LLP. It was established with a capital value of £94 million with Lloyds Banking Group, the Royal Bank of Scotland, Santander, Clydesdale Bank, the Strathclyde Pension Fund, the ERDF, and Highland and Islands Enterprise as investors and members of the Limited Partnership alongside SE.

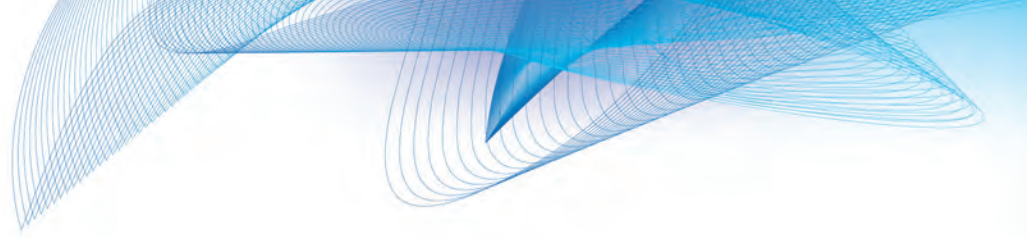
Whilst 2010/11 involved a considerable amount of development work for the Scottish Investment Bank and the Scottish Loan Fund, and against a continuing backdrop of difficult market conditions, we have delivered another solid performance, investing £23 million into 109 different companies and leveraging £53.7 million of private sector investment.

Last year became our most fruitful year to date in terms of income, achieving seven exits with £10.8 million generated from our portfolio compared with £3.5 million in the previous year. However, this is an area that will require continued effort in a market where exits are taking longer to achieve.

There is no doubt that we are now operating in a more challenging business environment than we have faced in many years but with the support of our stakeholders and the professional dedication of the Scottish Investment Bank team, we can look forward with optimism as we continue to make a positive contribution to economic growth and continue to develop the Scottish Investment Bank offering.

**Gerard Kelly**  
Head Scottish Investment Bank

*October 2011*



## Investment strategy

**The Scottish Investment Bank operates as a division of SE and is responsible for delivering its suite of investment funds and for managing SE's investment in the Scottish Loan Fund.**

We work with growth and export SMEs whether they need £20,000 to test an idea or £2 million to develop a new market area. We invest at seed, early and development/expansion stages, and have the ability to follow our investment. Ultimately, our goal is to support Scotland's economic development by growing Scotland's private sector funding market to ensure that both early stage and established SMEs with growth and exporting potential have adequate access to growth capital.

Our equity funds are designed to stimulate and support the market by providing a funding escalator that addresses the needs of early stage companies at key stages in their development. Growth potential and commercial viability are the key investment criteria, together with management skills and availability of matching private sector funding. The funds are complemented by the Scottish Loan Fund which provides growth capital to established businesses that are at the stage where they can service a loan. The Scottish Loan Fund offers mezzanine loans of between £250,000 and £5 million to qualifying SMEs.

Our funds provide support where the existing funding market would not provide the necessary funding at the levels required to support the growth of firms that have the potential to create jobs and drive significant economic growth in Scotland. In the case of the equity funds our approach is to co-invest on a fully commercial basis alongside the private sector. We recognise the important additional skills and expertise that external private investors bring to Scottish companies, and have a proven track record of attracting new international investors to Scotland.

## The market

**Independent evidence indicates that many SMEs in Scotland continued to experience difficulties in accessing finance during 2010/11, to support their growth ambitions. In addition, investors are finding it difficult to raise finance as economic conditions remain uncertain.**

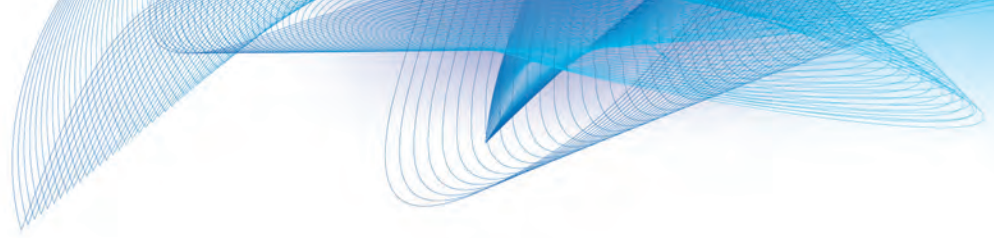
Scotland's Venture Capital (VC) and early stage market has continued to show evidence of segmentation. The expansion capital market has been characterised by VC investment in existing portfolio companies and the start up and expansion risk capital market characterised, for the most part, by business angel syndicates investing in new and expanding markets. As a result of the recession this has become even more pronounced with the business angel market increasingly deploying a "cradle to exit" investment model with established players seeking to realise the growth potential of portfolio companies over a longer period of time.

Observed reductions in early stage venture capital investment and bank lending have resulted in increased demand for angel funding, and in particular for angel investors to provide greater financial support to their existing investee companies. Established angel investors, operating through syndicates, have been concentrating on follow on investments. As a result, investment in start ups and new companies is even more challenging and reliant on new angel syndicates and other investors entering the market for the first time with new funds to invest.

The limited number of exit opportunities is an ongoing challenge, constraining the recycling of capital and the appetite to invest in earlier stage and new deals. For the Scottish Investment Bank, the challenge continues to be to balance the demand for increasing amounts of follow on funding for existing investee companies, while at the same time, making investment available alongside our private sector partners, to more new companies and start ups.

The most recent annual report available on the Business Angel market in the UK 2009/10<sup>1</sup> shows an overall decline in angel investment of 25%, whereas the position in Scotland was almost unchanged from the previous year. In contrast to the rest of the UK, Angel Groups in Scotland had a much greater focus on the early growth stage and made fewer investments in established companies, but were making a higher proportion of follow on investments.

The stable level of investment activity in Scotland can be attributed to the impact and participation of the Scottish Investment Bank in the majority of angel deals in Scotland.



## Performance highlights

**Despite the difficult economic conditions, we achieved seven successful exits delivering income of £10.8 million across the funds. We also completed 125 investments, adding 41 new companies to our portfolio and increasing the total number of active companies managed by the Scottish Investment Bank to 241. A high proportion of the investee companies are at a very early stage in their development (35% are pre-revenue) and are actively seeking to commercialise and take their new products to market. This reflects the focus of the funds on early stage and technology orientated companies who spend money on wages, materials, services and R&D prior to having turnover to cover this expenditure.**

The 241 companies in the Scottish Investment Bank portfolio support 3,441 Full Time Equivalent (FTE) jobs in the Scottish economy. Of these jobs, 2017 are in the creative industries and technology sector, 525 in life science companies and a further 295 in the energy sector. Total annual turnover in Scottish Investment Bank investee companies amounts to £278 million, based on the most recently available year end accounts. Again, this is dominated by companies in the creative industries and technology sector (£176 million), followed by life sciences (£30 million) and energy (£31 million).

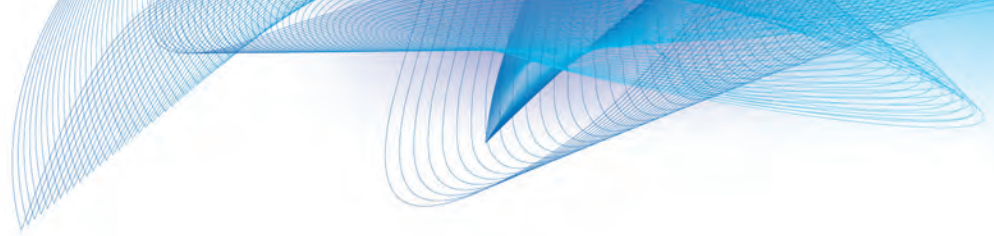
Independent evidence provides a strong endorsement of the contribution the funds are making and have the potential to make, towards economic growth. The contribution of the SIB funds to the development of the Scottish early stage risk capital market remains strong, both in terms of attracting new funding and investors.

The contribution made to individual company performance is also recognised. The funding is helping businesses get to market more quickly, to increase sales, expand into new markets and develop intellectual property. Whilst the wider market that has changed considerably, and may change further in future, the evidence strongly indicates that the Scottish Investment Bank should seek to continue to build on the current successful approach.

Our focus continues to be on establishing and maintaining relationships with private sector partners that offer expertise and additional capital to Scottish growth companies. During 2010/11, we established partnering arrangements with an additional six new partners (two Scottish Venture Fund and four Scottish Co-Investment Fund). We are currently working with 82 private sector partners.

## Key achievements 2010/11

Total Scottish Investment Bank investment	<b>£23.2 million</b>
Total private sector investment	<b>£53.7 million</b>
Leverage ratio (public:private)	<b>1:2.3</b>
Total deal value	<b>£76.9million</b>
Deals	<b>125</b>
Companies backed	<b>109</b>
New portfolio companies	<b>41</b>
Portfolio companies	<b>241 (at 31 March 2011)</b>
Portfolio jobs supported	<b>3,441(FTEs)</b>
Combined portfolio turnover	<b>£278 million</b>
Income	<b>£10.8 million</b>



## Business sector analysis

**As in recent years, three sectors dominated our investment activity for 2010/11, accounting for 87% of all deals, by value, completed during 2010/11:**

- Creative Industries and Technology (37%)
- Life Sciences (37%)
- Energy (13%)

Our figures for creative industries and technology sectors, suggest that early stage investors have a strong focus on companies in web-based services and software, telecoms, and mobile phone applications. Our life sciences investment activity during 2010/11 was predominately in biotechnology, medical and health as opposed to drug discovery and development – with angel syndicate partners accounting for the bulk of this activity.

Year on year, we have seen an increase in investment levels in energy companies via the Scottish Investment Bank funds, and in particular, the Scottish Venture Fund, due to the larger amounts of capital required in this sector. Investments in renewable energy and clean technologies require larger capital investment at the start up stage and Scotland has a global market advantage in the development and exploitation of marine renewables, which is a market that predicted to grow rapidly over the next several years.

2010/11 Investments by SE Business Sector	
Business Sector	Scottish Investment Bank
Creative Industries and Technology	£8,686,664
Life Sciences	£8,530,713
Energy	£3,099,677
Food & Drink	£1,016,000
Other Sectors	£579,350
Construction	£349,990
Tourism	£315,000
Financial Services	£249,518
Chemical Sciences	£210,866
Forest and Timber Technologies	£100,000
Aerospace, Defence and Marine	£40,000
<b>TOTALS</b>	<b>£23,177,778</b>

## Deal making highlights

During 2010/11, much of the market was focussed on consolidating investment portfolios and increasing the amount of funds committed to existing investments with a consequently reduced focus on new deals. Despite this, we continued to invest a significant proportion of our funds into new deals and start up companies: driven predominately by our efforts in building relationships with a number of new investors (primarily through the Scottish Seed Fund and Scottish Venture Fund) to jointly invest in exciting new prospects.

### Deal highlights:

*The Scottish Seed Fund provides equity investment from £20,000 to £250,000 early stage, growth orientated companies which meet specific criteria relating to their size and commercial viability.*

### Blipfoto Ltd

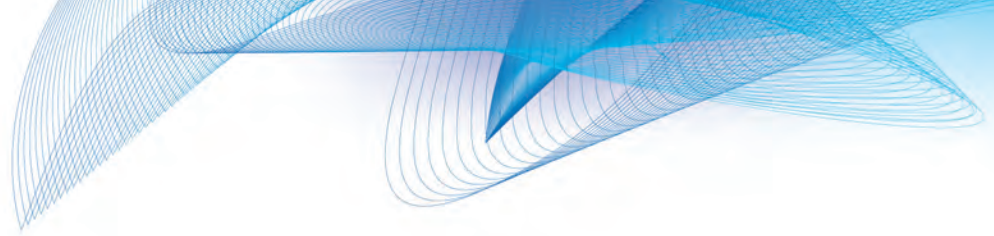
Edinburgh based online photo sharing journal service, Blipfoto Ltd, completed its first round seed investment in December 2010. The £200,000 deal was concluded via the Scottish Seed Fund alongside external investors with the investment being used to finalise product development and take the company into the initial commercialisation phase.

Led by CEO and founder Joe Tree, the company has made significant progress since it was established in 2006 and has ambitious growth plans for the future. With the emphasis on being a creative and discerning online photo sharing network, distinct from its competitors, Blipfoto has forged key partnerships and shared content with Channel 4, the National Theatre for Scotland and The Guardian which has assisted in the development of the Blipfoto community.

The company has resisted the opportunity to increase revenues by providing advertising space and members pay a small annual subscription to join the site, thus, giving the site an authentic artistic integrity feel. This allows the company to build on its ambitions for creating and harnessing a 'clean, calm and contemplative space'.

Blipfoto is a great example of the ever growing and increasingly significant creative industries sector in Scotland and in 2009, the company won a Bafta Scotland award for innovation, with SE chief executive, Lena Wilson, presenting the award.





**The Scottish Co-investment Fund**, part funded by ERDF, invests between £100,000 and £1million alongside the private sector in company finance deals of up to £2 million.



### Star Net Geomatics Ltd

The innovative Livingston based surveying, inspection and design services company, Star Net Geomatics Ltd (Star Net) received funding from the Scottish Co-investment Fund in a deal led by Par Fund Management Ltd. The Scottish Co-investment Fund invested £149,500 in March 2011 as part of a total funding round of £500,000.

Star Net, which was established in 2000, is organised across four key areas of expertise: geomatics; laser scanning; telecom site development and telecom site services. Deploying its high definition laser scanning, post-processing and innovative customer-facing software suite, Star Net provides clients with surveying and asset management solutions that capture detailed images of structures such as telecommunications towers and masts, power generation infrastructure and oil and gas installations. The three dimensional images generated are stored electronically and can be accessed and manipulated by clients using a dedicated software platform which has been developed by Star Net.

The investment will allow Star Net to follow through on its plans for accessing international markets, particularly in the mobile telecommunications sector.

**The Scottish Venture Fund**, part funded by the ERDF, invests between £500,000 and £2 million alongside private sector partners, in company finance deals of between £2 million and £10 million.



### Metaforic

The Scottish Venture Fund participated in a £5 million financing package for Metaforic, the Glasgow based software security company. The deal was led by Scottish Equity Partners with support from original investors Pentech Ventures. The funding will enable the company to expand its international sales and marketing capabilities and Glasgow based software engineering team.

Founded in 2006, with core technology from the former SE-backed Intermediate Technology Institutes (ITIs), Metaforic's core business is software security. Its two main products: MetaFortress (anti-tamper) and MetaSure (secure storage) are being utilised across a variety of markets, including gaming, business software and embedded hardware. These products offer software solutions that prevent revenue loss through product piracy and provide the reassurance that customers require, by ensuring that software can effectively resist cyber sabotage.

Developed over a number of years, the technology is proven in its field and now in North American, Asian and European markets. With a strong management team at the helm, it is anticipated that the company can capitalise on its current market position and take advantage of evident growth opportunities.

## Our portfolio

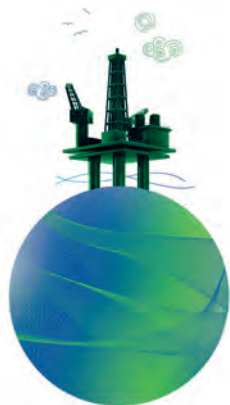
**The portfolio management approach adopted by the Scottish Investment Bank is based on proactive investment management combined with joint working initiatives alongside other areas of SE support, such as account management, to provide an added value support service and product offering. As well as follow-on investments and restructuring of existing investments, portfolio managers work closely with company management teams and private investment partners to support the development and growth of investee companies, ensuring that economic and commercial returns are optimised.**

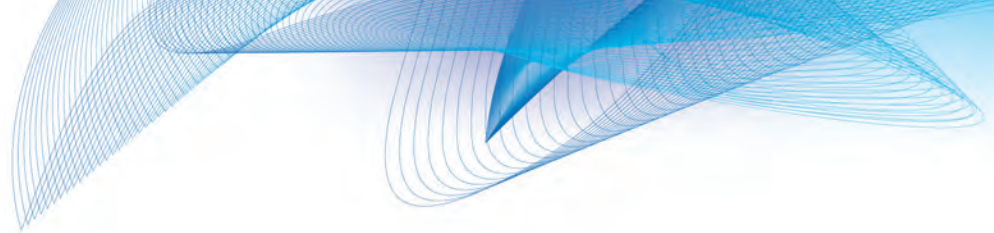
Portfolio managers work with colleagues throughout SE to identify areas where cross-collaboration can yield tangible benefits. SE products and services are strategically targeted towards companies where they will have the greatest economic and commercial impact. This collaborative approach to working has produced strong relationships with colleagues in account management, the sector teams and SDI, amongst others.

### **Nessco Group Holdings Ltd**

Nessco is a leading global provider of communication solutions and services to the oil and gas industry. The company provides turnkey telecommunication network solutions for infrastructure projects, including offshore platforms and onshore processing facilities such as refineries, liquefied natural gas plants and gas and petrochemical plants. Integrated system solutions are custom designed, engineered and built, based on the customer's specifications and requirements, as well as international industry standards and best practices.

Founded in 1979, Nessco currently employs more than 100 staff across its overseas offices in Azerbaijan and Brazil and its headquarters in Aberdeen. The company received a £4 million equity investment in 2008, which was part of a larger overall funding round. The Scottish Venture Fund participated in this deal which allowed the company to expand its international operations.



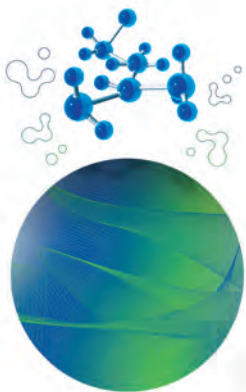


### **Blackford Analysis Ltd**

SE's High Growth Start Up Unit introduced Blackford Analysis Ltd to the Scottish Investment Bank in the summer of 2010. The Edinburgh based software company is a spin out from the institute of Astronomy at Edinburgh University. The Scottish Investment Bank invested via the Scottish Seed Fund in July 2010, in a start up round which saw investment from US based angel investors, as well as private individuals.

The company's patented software was initially developed for the purpose of determining the age of stars in the Universe but can now be deployed in other sectors. In the healthcare sector for example, the technology can offer an increase in radiologist throughput for medical imaging, suitable for MRI with CT scan applications. This allows the scan to be instantly aligned, thereby saving time for every patient set up. The underlying technology has wider applications wherever the rapid interpretation of massive data sets is required.

This is a very good example of the joint efforts of SE, coming together across all the disciplines to support a growth potential company. As well as working with SE's Proof of Concept Team, the High Growth Start-up Unit and the Scottish Investment Bank, the company also received a SMART: SCOTLAND Feasibility Study Grant of £70,000 to extend the registration engine's capabilities.



### **Lab901**

Longstanding Scottish Investment Bank investee company, Lab901 was sold in February 2011 to the world's leading measurement company, Agilent Technologies Inc. in a deal that represented a very good outcome for the Loanhead based life sciences company.

Lab901 was established in 2001 and at the point of sale, employed 45 people. The company specialises in electrophoresis equipment and consumables with its automated electrophoresis products being used for DNA, RNA and protein analysis. The Scottish Investment Bank invested £2.36 million in the company since 2003. The combination of its innovative technology and products, allied to its experienced management team, proved to be an appealing prospect, with the acquisition an ideal fit for Agilent's culture and history.

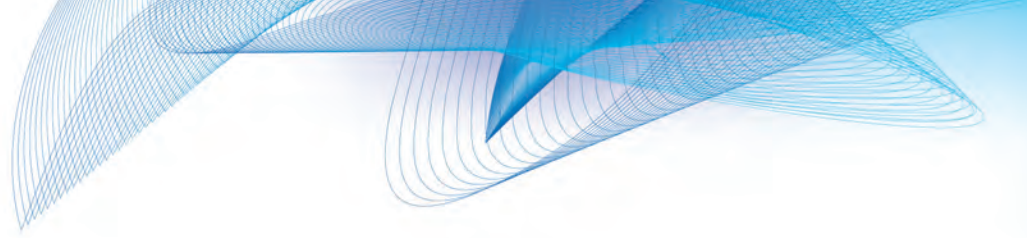
With Lab901's products considered to be complementary to Agilent's electrophoresis portfolio, Lab901 was integrated into Agilent's Liquid Phase Analysis Division. Agilent's management team is excited about the future potential of Lab901, as part of a global organisation, the company can look forward to a very bright future anchored in Scotland.

## Future direction

**Despite challenging market conditions during 2010/11, steady progress was made delivering the existing suite of equity funds. The level of activity in Scotland and the amount of finance available to early stage and often pre revenue and technology orientated companies with growth potential has been maintained. The remit of the Scottish Investment Bank has also been extended with the introduction of the Scottish Loan Fund to support established SMEs with growth and export potential.**

With the economy yet to show significant positive signs of recovery, our focus on growing the early stage risk capital market is vital to address the gaps and market failures that are constraining company growth at the critical start up and early stages. With limited public sector resources, the evidence suggests that we have been successful in targeting those with the greatest potential to contribute to economic growth, and positively contribute to Scottish Government growth targets. A key challenge for us will be to identify alternative sources of capital, both public and private, to allow us to continue our support and to develop new products or initiatives where required.

We will continue to focus on building successful delivery mechanisms, working with the private sector, sharing risk/reward and leveraging in private sector expertise and finance. We will seek to optimise the commercial returns achieved by our investee companies, and to provide an integrated package of support from across SE to help companies achieve their growth and export potential.



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