**Interim Review of**

**The Scottish Co-Investment Fund III**

**and**

**The Scottish Venture Fund III**

**Scottish Enterprise**

**Economics**

**and**

**Commercial**

**Teams**

**October**

 **2018**

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**Executive Summary**

**The Funds**

**1.** The Scottish Co-Investment Fund (SCF) and the Scottish Venture Fund (SVF) were set up in 2003 and 2006 as pan-Scotland funds to be managed by the Scottish Investment Bank (SIB). They are to increase the supply of early stage risk capital to small, innovative, Scottish based companies. They are delivered in slightly different ways, although both operate on the co-investment principle with the co-investors taking the investment lead.

**2**. . Both Funds are capitalised through Scottish Enterprise’s (SE) core budget and by the European Regional Development Fund (ERDF). Since they were set up they have been recapitalised three times.

**3**. They operate under the Market Economy Operator Principle (MEOP) to ensure that they comply with State Aid regulations. This means that, amongst other things, the Funds must invest on equal terms with private sector investors.

**Review’s Purpose**

**4**. The purpose of the Review, of Phase III of both Funds, was to support their re-approval. Although SE Board approval runs until December 2018, the current rate of investment meant that the Funds would be fully drawn down before then. There was also a further ERDF award available. Accordingly, evidence of the Funds’ performance was need both to gain SE board approval[[1]](#footnote-2) and to support the ERDF application.

**5.** The Review was undertaken by SE’s Appraisal and Evaluation and the Commercial Teams. It involved desk research, data analysis and a series of face-to-face and telephone interviews with SE staff, investors and investees.

**The Funds’ Investments**

**6.** The rationale for establishing the Funds was to fill an equity gap in the £0.5 to £2 million range where sound investment propositions found it difficult to attract equity. This reflected such things as limited capacity within Scotland to support such deals, relatively high transactions costs (such as due diligence) and perceptions of risk.

**7.** During Phase III of the Funds (July 2015 to September 2017) 163 companies received £68 million in 293 separate investments. This levered a further £148 million from other sources, a leverage rate of 1:2. For both Funds Enabling Technologies and Life Sciences were the dominate sectors, accounting for around two thirds of all companies supported. The average deal size was £0.9 million for SVF and £0.6 million for the Co-Investment Fund. To date there have been 2 exits from the Funds, both from SVF, giving a net loss of £2 million.

**The Funds’ Delivery and Effectiveness**

**8.** The key finding from the interviews was that the two Funds had been very effective in providing investment capital that would otherwise not have been available. They had also been very effective in growing the investor base within Scotland. This was especially the case for the Angels and Angel Syndicates where SIB, alongside LINC[[2]](#footnote-3), had increased the number and quality of the Angel investment community. The involvement of SIB in the Funds was seen as giving investments a “seal of approval”, a “badge” as one investor expressed it.

**9.** The concerns that were expressed, need to be interpreted in the context of funding interventions that are meeting their objectives. These included such things as: a feeling that too much money was going into follow-on rather than new investments; a perception that SIB’s involvement in follow-on was not always necessary as the money could be raised elsewhere; the need to have an explicit exit strategy: and the limited capacity of some Angel Syndicates.

**10.** Some of these concerns would seem to indicate the need for a more effective communications strategy (with investors, investees and stakeholders) as they are often based upon misconceptions of SIB’s role and its need to act in a way that was MEOP compliant.

**The Funds’ Economic Impact**

**11.`** The assessment of the economic impact of the Funds was based upon recent evaluation evidence and the qualitative interviews with investors and investees. However, some adjustments were made to the additionality assumptions, reflecting changed circumstances since the evaluations were completed. These involved a small deadweight adjustment and increases to the time to exit.

**12.** Based upon the amount invested through the two Funds, it is estimated that the Impacts to date are relatively modest. However, this is to be expected given the early stage of many of the investments. Over a ten year time horizon the Impact Ratio (net GVA per £1 of SIB support) is estimated to be 10:1 for SCF and 4:1 for the Venture Fund: an average of 6:1 for the combined Funds. The two Funds are estimated to have created 1,100 jobs over ten years. Although the Cost per Job (£60,000) seems high, this needs to be seen in the context of the type of high value jobs that are likely to be created.

**13.** In addition, there will be other benefits, for example additional investment in innovation and Research and Development and increased exports. It also needs to be remembered that the intention is to realise the investments. When this is done then the Impact Ratios will increase and the Cost per Job will fall.

**Conclusions and Recommendations**

**14.** The overall view was that the Funds were very effective. They had resulted in risk mitigation so that there was now more investment capital in the early stage market. Indeed, it was felt that below £1 million there was now an adequate supply of capital albeit this was only the case because of SIB’s intervention. This remained an inherently risky area where public sector intervention was needed for the foreseeable future.

**15.** Given that the review endorsed the effectiveness of the Funds a limited number of recommendations were made:-

* SIB should review its communications strategy with stakeholders, investors and investees and ensure that policy and procedures, and any changes to them, are made explicit;
* Consideration should be given to formulating an explicit exit strategy from investments that is communicated to stakeholders as appropriate;
* Consideration should be given, when making follow-on decisions and where other private sector funding may be available, to making its operating model (including operating in a commercial basis) clear to stakeholders, investors and investees; and.
* Consideration should be given to the potential for assessing performance of the companies invested in through the various Funds since their inception, to determine their longer-term impact upon company growth.

**Foreword**

This Interim Review of the Scottish Co-Investment and Venture Funds III was undertaken by members of Scottish Enterprise’s Economics and Commercial Teams. The work was carried out between October 2017 and May 2018.

During the work several people with an interest in the Funds (as investors, investees and stakeholders) and the Scottish Investment Bank were interviewed. We are grateful for the time they given to us and their openness. At the start of each interview it was stressed that their views would be treated in confidence. The report has synthesised these views to arrive at a balanced set of conclusions. Where a minority of interviewees have expressed an opinion, this is reported. The interpretation and conclusions are those of the Review Team and not the interviewees.

James Coggs, Keith Hayton, Paul Padaruth and Heather Quigley

**1. The Review**

**Preamble**

**1.1** TheScottish Co-Investment Fund (SCF) and the Scottish Venture Fund (SVF) were established by Scottish Enterprise (SE) in 2003 and 2006 respectively as pan-Scotland funds, currently delivered by the Scottish Investment Bank (SIB), SE’s investment arm. Although they have similar aims (to increase the supply of early stage risk capital to small, innovative Scottish based companies) they operate in slightly different ways. SCF is delivered through approved accredited partners who are responsible for selecting, and making, the investments with SCF investing on equal terms. Accredited partners are recruited following an application and diligence process and are regularly reviewed as to their continued suitability. SIB’s role is to provide investment capital on equal terms but it does not play an active role in the investment decision. SVF is managed and delivered by SIB through its Transaction and Portfolio Specialists, without accredited or formal “partners”, although all investments are led by private sector co-investors. Thus, both Funds are based on the co-investment principle with the co-investors taking the lead.

**1.2** Although the Funds operate in slightly different ways they are funded in the same way: through SE’s core budget and partly by an award from the European Regional Development Fund (ERDF) which currently is awarded by the Scottish Government’s SME Holding Fund[[3]](#footnote-4). The Funds have been recapitalised 3 times.

**1.3** The Funds operate under the Market Economy Operator Principle (MEOP)[[4]](#footnote-5) to ensure that they comply with State Aid regulations. MEOP determines whether a transaction entered into by a public body gives an advantage to a particular economic undertaking and therefore falls within the State Aid regime.  An economic transaction carried out by a public body does not constitute State Aid if it is carried out in line with normal market conditions, that is if it is deemed that rational market operator would have entered into a transaction on the same terms as a public body did. It should be noted that state aid can be deemed to apply at any level: at the SME level but also at the investor level, so the decisions and actions/inactions need to take both into account (so a benefit cannot be conferred to an investor). Both Funds invest on equal terms with private sector investors (*pari passu* - equal risk, equal reward)as the simplest way of evidencing MEOP.

**Introduction**

**1.4** This Interim Review was undertaken by a team of four SE staff:-

* James Coggs and Keith Hayton from the Economics Team; and
* Paul Padaruth and Heather Quigley from the Commercial Team.

**1.5** None of the Team worked in, or for, SIB, which delivers both Funds on behalf of the Scottish Enterprise. This means that it was possible to bring a degree of impartiality to the review.

**The Review’s Purpose**

**1.6** The SE Board approval for the two Funds runs until December 2018. The current rate of investment means that the approved funds will be fully drawn down before then so there will be a need for early re-approval. If approved then the Funds will be able to run for a further three years subject to budgets[[5]](#footnote-6). There is also a further ERDF award available for applications in mid 2018 with an award expected in summer 2018.

**1.7** To support the approval and application, it is necessary to have evidence of the Funds’ performance supplemented by the views and opinions of investors, investees and other stakeholders. This is the purpose of this report.

**Objectives**

**1.8** The Review aims to:-

* Consider the rationale for public sector involvement in the provision of risk capital to private sector companies, and assess if the original rationale underpinning the Funds is still valid;
* Assess the impact of the Funds on the supply of capital to businesses in Scotland, highlighting changes and the implications of these;
* Look at the outputs of the two Funds since they were last approved (May 2015). This is to consider the number of investments made, their sectoral distribution, other investment patterns, new investments and investments into existing companies (follow-on);
* Consider the investment performance of the Funds in terms of the number of business failures, exits and return on capital to date;
* Obtain views on the Funds’ performance, management and delivery from investors and the investee companies;
* Assess the wider strategic context within which the Funds operate and the implications of any changes in this on the way the Funds operate and are managed;
* Assess the economic performance of the Funds in terms of net impacts: specifically, Gross Value Added (GVA) and employment; and
* Draw the evidence together and make recommendations that the Review Team feels could improve the operation and impacts of the Funds over the next three years.

**Methodology**

**1.9** The work has involved 3 stages:-

* A series of face-to-face and telephone interviews with 12 investors, 5 investees, 9 stakeholders (5 external and 4 internal) and SIB colleagues;
* Desk research reviewing the approval papers, earlier evaluations and reports setting the wider context for the provision of investment to small Scottish-based companies; and
* Analysis of the data collated by SIB on both the investments made and the performance of the investee companies.

**1.10** The interviewees were suggested by SIB as being knowledgeable about the Funds and raising capital more generally. The Review Team consider that these covered the required range of expertise and experience. However, although many interviewees had considerable experience of investing and raising capital, they were not necessarily aware of all the initiatives that SIB has been involved in nor were they always familiar with the detail of SIB’s processes and procedures.

**1.11** It should be noted that although the Review covered two Funds, for the most part it does not deal with these separately given that many of the investees have benefited from both Funds, whilst several of the investors have likewise made use of both. It is also the case that the Funds have essentially the same objectives, although they are differentiated by specific Fund parameters and the process for securing co-investment. The main exception to this is when the data on the Funds is analysed. As this is collated on a Fund-by-Fund basis, it has been analysed separately.

**1.12** The Review is structured as follows:-

* Section 2 provides details of the Funds, the pattern of investments and the performance of these to date;
* Section 3 looks at the rationale for public sector intervention in the provision of investment capital and the nature and evolution of the funding “gap” that it is aimed to fill;
* Section 4 outlines the main findings of the interviews;
* Section 5 reviews the evidence as to the economic impacts of the Funds and, based on this, looks at what the potential impacts will be of the Phase IV investments; and
* Section 6 draws conclusions and makes recommendations for Phase IV.

**2. The Funds**

**Introduction**

**2.1** The Funds were initially set up in the early 2000s. At the time they were created, they were part of a funding “escalator” aimed at meeting growth companies’ varying needs for investment. These included the:-

* Scottish Seed Fund through which SIB could invest up to £0.100 million (subsequently increased to £0.250 million);
* Scottish Co-Investment Fund with a maximum investment by SIB of £1.5 million;
* Scottish Venture Fund (a £2 million maximum); and
* Scottish Portfolio Fund which could provide follow-on funding to companies in the SIB portfolio that required support outwith the parameters of the other Funds.

**2.2** Over time the investment levels and other criteria have changed to reflect changing market conditions. Broad details of the origins and operations of the Co-Investment and Venture Funds are provided below.

**The Scottish Co-Investment Fund**

**2.3** SCF was first approved by the Scottish Enterprise Board in 2002, with the first partner agreement being signed in March 2003. It has since gone through several recapitalisations so that the current Fund (the focus of this Review) is SCF III which started in December 2015.

**2.4** SCF is supported through an ERDF funding award which can fund up to 40% of the value of eligible deals. It makes equity investments with approved partners, from £0.010 million to £1.500 million up to a maximum deal size of £10 million, and operates pan Scotland. SIB’s contribution, alongside other public sector equity investment, is not to exceed 50% of the total deal size. SCF can also provide follow-on funding.

**2.5** The rationale for its establishment was that there was an equity “gap” in the range £0.5 million to £1 million where otherwise sound businesses found it difficult to raise equity. This was (to summarise the 2017 evaluation of the Fund[[6]](#footnote-7)) because:-

* These investments were seen as high risk;
* There was limited capacity in Scotland to support these deals;
* Transaction costs, such as due diligence, tended to be fixed so that*, ceteris paribus,* there was a tendency for investors to prefer bigger deals; and
* There was limited capability in Scotland to undertake the necessary due diligence for technology based companies.

**2.6** The process of delivering support was summarised in the 2017 evaluation[[7]](#footnote-8):-

* At the launch of SCFIII there was an initial selection process whereby existing partners (who had been involved in SCFII) and potential partners (for example angel syndicates and Venture Capital companies) applied following a call by SIB. The applicants were assessed as to their investment track record, ability to add value to companies and capacity to secure follow-on funding to support company growth;
* Once selected, approved partners were given an upper investment limit per company that could be drawn down through SCF. This was based on their experience, historic investment levels and capacity to deliver the match funds. Generally, most partners have earlier experience of working with SIB, perhaps as investors in other Funds, so their capabilities were known;
* Additional partners were able to apply and be approved after the initial selection process;
* The accredited partners source, diligence and negotiate deals and must be willing to invest their own capital in the companies. If there is a funding gap, the partner can call upon the SCF to co-invest alongside it on commercial and equal terms. Some companies may be introduced by SIB or through other parts of SE such as Company Growth. As the partners are identified on the SE website, there are also independent applications. The investment decision will be based on the partners’ normal investment criteria (for example the scale of funding, risk and the sector the company is involved in);
* If the partner decides to invest, SIB can be approached to invest to fill the identified funding gap, with SIB providing up to 50% of the investment. SIB ensures that deals meet the eligibility criteria of the Fund and ERDF: there being certain sectors where investment is restricted (Appendix 1). SIB ensures, through the legal due diligence process, that it is investing on equal terms with the partner. Eligibility and the likely funding requirements are captured in the Transaction Introduction Paper (TIP). If all checks are satisfactory then, once the legal documentation is complete and the relevant paperwork is in place, the money is released and the deal is completed;
* SIB does not undertake its own company diligence but follows that of the partner. As the investment is in SE’s name a SIB Portfolio Specialist will be assigned to manage the investment alongside the SCF partner.
* If the investee company is not Account Managed[[8]](#footnote-9), it will be introduced to SE’s or Highland & Island Enterprise’s prospecting teams.
* Accredited partner performance is regularly reviewed by SIB with formal annual reviews. At any point partner status can be withdrawn if there is evidence that they are not performing in a way that is consistent with the expectations of the partner agreement.  This can relate to such things as how deals are transacted or how companies are supported by investors after the investment has been made; and
* Revisions to the partner application process after the 2015 approval saw applicants having to demonstrate in greater detail their investment track records, including their ability to add value to companies and the capacity to secure follow-on funding to support company growth.

**The Scottish Venture Fund**

**2.7** The SE Board agreed to set up the Scottish Venture Fund (SVF) in 2006. The Approval Paper outlined two main objectives:-

* Stimulate the development of the early stage investment market by increasing the amount of capital and the number of investors willing to put money into early stage Scottish-based companies; and
* Do this whilst operating on a fully commercial and risk sharing basis with private sector partners.

**2.8** In May 2015, approval was given for £75.4 million by SE’s Board until March 2018 for delivery of both SCF and SVF. Subsequently approval was given to increase this to £95.4 million (to be able to access a further £10 million through the ERDF). The timeline was also extended to December 2018. This formed SVF III. It is the May 2015 onwards funding that forms the focus of this Review (and the deals transacted between July 2015 and September 2017).

**2.9** SVF was established to allow SIB to co-invest alongside investors who were unwilling or unable to become SCF accredited partners. This can be for a variety of reasons: limited previous investment experience; the operation of the partners being an unknown; underperformance to date; or simply a desire not to have the obligations of a partnership agreement. The Fund therefore allows leverage of a more diverse investor base to support company investment.

**2.10** Like SCF, SIB does not source deals. These are brought to SIB by private investors when a funding gap has been identified. As there are no accredited partners (as with SCF), SIB assesses the deal and can undertake its own due diligence as appropriate before making the decision to invest, and is involved in the negotiations over terms of any investment deal. Investments are made on the same terms as private sector investors so that it is based on the same MEOP principle as SCF (see Paragraph 1.3).

**2.11** The process whereby investments are made is broadly as follows:-

* SIB has relationships with a range of investors, including individual angels, syndicates or venture companies, and continues to build more;
* The private sector investor(s) leads the deal and if there is a funding gap SVF can be called upon to co-invest on commercial and equal terms (*pari passu*) and, subject to SE’s standard legal requirements, can also invest alongside new and existing investors in follow-on deals. As with SCF, there are sectors where SIB investment is restricted (Appendix 1). SIB will also not invest in a company which is undergoing insolvency or in a “phoenix” company[[9]](#footnote-10). It can also decide not to invest at its own discretion;
* The private sector investor(s) carries out their own diligence, which is ideally shared with SIB, and this is supplemented by any SIB desk based or formal diligence (as appropriate). The private investor(s) generally negotiates the investment terms, although SIB may be involved and in some circumstances may request updated terms based on the results of its diligence; and
* As with SCF, a TIP is required at the initial introduction of the deal to assess eligibility, consider the high level economic impact, and the likely funding requirement.  An Approval to Proceed Paper then considers the proposition in more detail and SIB’s diligence approach. A Full Approval Paper makes a recommendation to invest.  All three papers are considered by SIB’s Investment Committee as an Advisory Group for SIB’s Director. The amount invested is the sum needed to make the deal go ahead subject to the maximum Venture Fund deal size of £2 million per annum. All transaction documentation will be reviewed on behalf of SIB by external lawyers appointed by SE’s Framework for lawyers.

**The Funds’ Performance to Date - Desk Analysis**

**2.12** In Phase III of the Funds, to date (July 2015 to September 2017) there have been 293 separate investments, with SIB investing £68 million in 163 unique companies. The deals were evenly split across the Funds: 144 through SCF and 149 through SVF. Table 2.1 shows the breakdown by Fund. SIB’s investment has levered a further £148 million from other sources: a leverage ratio of 1:2 ranging from 1:2.13 for SVF to 1:2.28 for SCF. The average investment per company varies, with companies funded through SVF receiving, on average, 47% more funds that those supported through SCF which is not surprising given the latter’s higher investment limit (£2 million).

**TABLE 2.1 Funds invested during Phase III**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **FUND** | **Number of Companies**  | **Number of deals** | **Amount Invested by SIB**  | **Amount Leveraged** | **Total Deal Value**  | **Average Investment per company** |
| **SCF III** | 80 | 144 | £24,470,941 |  £55,716,057  | £80,186,998 | **£1,002,337** |
| **SVF III** | 92 | 149 | £43,305,627 | £92,274,047 | £135,579,674 | **£1,473,692** |
| **TOTAL/AVERAGE** | **163\*** | **293** | **£67,776,568** | **£147,990,104**  | **£215,766,672** | **£1,323,722** |

**Note:**

**1.** Nine companies received both SCF and SVF investment during Phase III

**2.13** In many cases, a company was supported with more than one deal during Phase III. Of the 163 unique companies supported, 56 (34%) received investment support for the first time - the remaining two thirds were receiving follow-on support. These 56 companies accounted for 40% (£26.9 million) of investment by SIB over the period. Thus 60% of investment was follow-on supporting existing investees.

**2.14** Table 2.2 shows that the average SCF investment was £170,000 per deal. This was 41% lower than the average SVF investment over the same period (£287,000). In terms of overall deal size, the same pattern holds true, with SVF supported deals on average 39% larger than those funded through SCF. This is due to the SCF supporting volume investors (with most partners having several investments) whereas the SVF investors have fewer or one-off investments that tend to be bigger.

**TABLE 2.2 Average Deal Size by Fund**

|  |  |  |  |
| --- | --- | --- | --- |
| **Fund** | **Number of deals** | **Average SIB Investment per deal**  | **Average overall deal size**  |
| **SCF III** | 144 | £169,937 | £556,854 |
| **SVF III** | 149 | £286,792 | £909,931 |
| **Total** | **293** | **£231,319** | **£736,405** |

**2.15** SIB works in collaboration with partners and co-investors managing investments. As part of its monitoring, SIB assesses each of its investments according to its performance against the company’s Business Plan (Table 2.3) on several broad criteria. The data shows that:-

* Almost two thirds (60%) of investments were performing behind plan, slightly more in the SCF;
* 34% were performing to plan;
* Only 2 companies were performing ahead of plan; whilst
* 2% (6 companies) were insolvent.

**2.16** These figures need to be interpreted in the context of many of the investees being small, early stage companies that are involved in inherently risky, disruptive technologies. Also, that when producing a business plan that aims to attract investment, companies will invariably be optimistic and as such it should be no surprise that almost two thirds were behind plan. Given this, the use of business plan performance as a monitoring measure may be of limited value.

Performance against business plan is only one of the factors SIB monitors alongside co-investors. Other factors include cash burn, business milestones (e.g. launch of new products), regulatory approvals, sales pipeline, management and other key appointments, as well as macro and general economic factors which impact performance and growth.

**TABLE 2.3 Investment Performance**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Category** | **SCF III** | **SVF III** | **Both Funds** | **Overall** |
| **Number** | **%** | **Number** | **%** | **Number** | **%** | **Number** | **%** |
| **Performing - Behind Plan** | 46 | 65% | 48 | 58% | 3 | 33% | 97 | 60% |
| **Performing - To Plan** | 23 | 32% | 27 | 33% | 5 | 56% | 55 | 34% |
| **Performing - Ahead of Plan** | 0 | 0% | 2 | 2% | 0 | 0% | 2 | 1% |
| **Non-Performing – Solvent** | 1 | 1% | 0 | 0% | 0 | 0% | 1 | 1% |
| **Non-Performing – Insolvent** | 1 | 1% | 4 | 5% | 1 | 11% | 6 | 2% |
| **Blank** | 0 | 0 | 2 | 2% | 0 | 0% | 2 | 1% |
| **TOTAL/PERCENTAGE** | **71** | **100%** | **83** | **100%** | **9** | **100%** | **163** | **100%** |

**Note:** Percentages may not add due to rounding.

**2.17** Analysis by sector (Table 2.4) shows that the SCF III investments have been dominated by two sectors, Enabling Technologies and Life Sciences. Together these account for 68% (54) of the companies supported and 77% (£18.8 million) of the money invested. A further 14% (£3.4 million) was invested in Creative Industries companies. Other sectors received relatively small amounts of investment. The Table also shows that:-

* The average investment varies considerably across the sectors with Financial Services, Life Sciences and Enabling Technologies receiving a third to a tenth more on average per company; and
* At the other extreme average investments in sectors such as Textiles and Food and Drink are well below the average.

It may be unwise to read too much into the average spend as this will reflect several factors such as the sectoral priorities of the partners, opportunities, the existence of other sources of financial support, different business models, and the cost and time needed to bring products and services to market

**TABLE 2.4 SCF III Investments by Sector**

(Ranked by number of companies in each sector)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Sector** | **Companies** | **Percentage** | **Amount** | **Percentage** | **Average Investment per company** | **Percentage variance from Fund average** |
| **Enabling Technologies** | 30 | 38% | £10,380,385 | 42% | £346,012 | +13% |
| **Life Sciences** | 24 | 30% | £8,449,554 | 35% | £352,065 | +15% |
| **Creative Industries** | 12 | 15% | £3,419,880 | 14% | £284,990 | -7% |
| **Food and Drink** | 3 | 4% | £326,537 | 1% | £108,845 | -64% |
| **Other** | 3 | 4% | £293,044 | 1% | £97,681 | -68% |
| **Chemical Sciences** | 2 | 3% | £284,556 | 1% | £142,278 | -53% |
| **Energy – Other** | 2 | 3% | £432,120 | 2% | £216,060 | -29% |
| **Financial Services** | 2 | 3% | £785,870 | 3% | £392,935 | +29% |
| **Textiles** | 2 | 3% | £98,995 | 0% | £49,498 | -84% |
| **Energy – Renewables** | 0 | 0% | £0 | 0% | £0 | 0% |
| **TOTAL/AVERAGE** | **80** | **100%** | **£24,470,941** | **100%** | **£305,887** | **N/A** |

**2.18** A similar pattern was seen in the analysis of SVF III (Table 2.5) with Enabling Technologies and Life Sciences again representing most of companies supported (56: 61%) and money invested (£23.2 million: 53%). However, despite accounting for 33% of the companies supported, only 22% of investment in financial terms was provided to Enabling Technologies companies, which suggests that although there have been many investments in the sector, the size of these investments has been smaller in comparison with others. When the extent to which investment by sector varies from the Fund’s average is considered some interesting patterns emerge:-

* The largest average investments are in Food & Drink companies (double the Fund’s average) followed by Chemical Sciences and Energy - Other;
* At the other extreme Financial Services, Aerospace Defence & Marine and Enabling Technologies receive investments that are around a third less than the average; and
* This is quite a different pattern to that shown by SCF III.

As with the SCF III sectoral analysis, caveats need to be given. Not only may these patterns reflect the partners’ sectoral priorities but the Venture Fund is investing alongside a different group of co-investors in companies at a different stage in their growth where the capital needs are likely to differ.

**TABLE 2.5 SVF III Investments by Sector**

(Ranked by number of companies in each sector)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Sector** | **Companies** | **Percentage** | **Amount** | **Percentage** | **Average Investment per company** | **Percentage variance from Fund average** |
| **Enabling Technologies** | 30 | 33% | £9,720,764 | 22% | £324,026 |  -31% |
| **Life Sciences** | 26 | 28% | £13,483,367 | 31% | £518,591 |  +10% |
| **Creative Industries** | 17 | 18% | £8,048,348 | 19% | £473,432 |  +1% |
| **Energy – Other** | 6 | 7% | £4,369,862 | 10% | £728,310 |  +55% |
| **Energy – Renewables** | 5 | 5% | £1,872,343 | 4% | £374,469 | -20%  |
| **Food and Drink** | 4 | 4% | £3,775,049 | 9% | £943,762 |  +101% |
| **Chemical Sciences** | 2 | 2% | £1,470,785 | 3% | £735,392 |  +56% |
| **Aerospace, Defence and Marine** | 1 | 1% | £295,509 | 1% | £295,509 | -37% |
| **Financial Services** | 1 | 1% | £269,600 | 1% | £269,600 |  -43% |
| **Textiles** | 0 | 0% | £0 | 0% | £0 | 0% |
| **Non-Priority** | 0 | 0% | £0 | 0% | £0 | 0% |
| **TOTAL/AVERAGE** | **92** | **100%** | **£43,305,627** | **100%** | **£470,713** | **N/A** |

**The Funds’ Investment Performance in Phase III**

**2.19** To date there have been two exits from the SCF III and SVF III both in 2016/17 and both from SVF. On one of these a loss was made, on the other a profit, giving a net loss of £2.002 million. In addition, as Table 2.3 shows, six of the investees are classed as “Non-performing insolvent”. SIB’s investment in these amounts to £5.233 million and there must be a risk that not all this money will be repaid.

**2.20** Over the SCF III and SVF III portfolios, SIB’s investment of £67.776 million has levered in a further £148.872 million from other investors: a leverage ratio of 1:2.19, varying from 1:2.13 for SVF to 1:2.28 for SCF (Paragraph 2.12).

**2.21** For comparison:-

* The 2017 evaluation[[10]](#footnote-11) of SCF II reported a leverage ratio of 1:1.64. For SCF III the leverage has improved; and
* The 2013 evaluation[[11]](#footnote-12) of SVF II reported a leverage ratio of 1:2.2[[12]](#footnote-13): essentially the same as for SVF III.

**2.22** On this comparator, performance for SCF III and SVF III is therefore similar to that reported for the earlier Funds.

**Conclusion**

**2.23** On the few comparators available (chiefly leverage) the Funds would seem to be performing similarly to the earlier Funds.

**2.24** Two thirds of companies were behind on their business plan forecasts, although this is likely to reflect the early stage nature of the portfolio. A number of metrics, as well as performance against business plan, are used to manage overall performance of the investment.

**2.25** A large amount of investment continues to go into follow on investment. This is looked at in greater detail in Section 4 (Paragraphs 4.17 to 4.25).

**3. The Rationale for Intervention**

**Introduction**

**3.1** The generally stated reason for the public sector being involved in the provision of investment capital for private sector companies is because new start and pre-revenue companies find it difficult to raise money in the market. This is also the case for more established companies requiring larger amounts of investment. If the public sector did not provide support then, it is argued, economic development would be restricted. A concern is that innovative and disruptive technology companies would not be able to start up and then progress to a point where they are scalable companies. Given that these are the foundations of future prosperity, this is clearly of political and social concern.

**Risk**

**3.2** That the private sector does not ensure that sufficient risk capital is available is a rational response to what is a high-risk market. During the interviews, several experienced investors reported generally similar statistics. For every 10 investments, their experience is that:-

* One would grow significantly and produce major returns;
* 2 to 3 would give significant returns;
* A further 2 to 3 would produce respectable but lower returns, possibly just repaying the initial investment; and
* The final 2 or 3 would either produce losses due to the company closing or would be exited at a loss if it was felt that the company was stagnating and there was felt to be no prospect of growth.

**3.3** The figures quoted by individuals varied slightly but what was clear was that even those with in-depth experience of the early stage investment market, who undertook careful diligence before making an investment, were not always able to pick winners and avoid losers. This pattern has been reported in a range of research over the years and in other evaluations that SE has commissioned[[13]](#footnote-14).

**Structural Market Features**

**3.4** Linked to this are structural features of the market, in particular the geography of wealth distribution in the United Kingdom, with wealth being concentrated in London and the South East[[14]](#footnote-15), [[15]](#footnote-16). Thus, the number of High Net Worth Individuals[[16]](#footnote-17), of the type who are likely to be interested in becoming business angels, is far more limited in Scotland (and other English regions) than it is in the South East or more specifically the “golden triangle” of London, the South East and the East of England which SIB estimates accounted for 80% of equity investment and 70% of deals in 2016.

**3.5** The geography of institutions also follows this pattern, with the Venture Capital industry being again concentrated in the South East of England. For example, the Entrepreneurs Handbook[[17]](#footnote-18) lists 77 Venture Capital companies. Of these:-

* Sixty-eight are based in London;
* Four have Scottish bases, although 2 of these have offices spread across the UK regions so are not solely focused on Scotland;
* One is based in Northern Ireland;
* One in the West Midlands;
* One in Cambridge;
* One in Oxford; and
* One in Southampton.

**3.6** Although many investors claim that they invest across the UK, most Venture and Private Equity investments are made in the areas where the Venture companies are based. For example, the British Venture Capital Association’s map of members’ investments shows that 55% were in London, the South East and East Anglia. In contrast Scotland accounted for only 6%[[18]](#footnote-19). As one of the interviewees commented “*VCs don’t travel*”. Thus, all other things being equal, similar companies would seem likely to have a greater chance of raising capital if they are based in the South East rather than in Scotland.

**Market Failures or Features**

**3.7** Are the trends highlighted above market failures or, as earlier evaluations have said, market features?[[19]](#footnote-20) The above description of the capital market is focused upon the supply side. What is clear is that risk and failure is an integral part of investing, regardless of the depth of experience of the investors. Given this, much of the above is an outline of features of the market rather than of market failures, given that a degree of risk aversion is a normal reaction to uncertainty, which in this case is informed by experience.

**3.8** This apparent mismatch between the supply of investment capital and demand is, however, clearly an equity issue in so far as the consequences of being unable to secure sufficient investment in various geographies are of political and economic concern. Given this, public sector intervention can be justified because it is attempting to redress a spatial imbalance between the demand for, and supply of, risk capital.

**3.9** There may be other factors that limit the supply of capital. These were set out in the 2012 evaluation of the Venture Fund[[20]](#footnote-21) and are still relevant:-

* Limited information on potential investment opportunities, which the interviews for this Review found still to be an issue;
* The high cost of undertaking diligence, which tends to be a fixed cost regardless of the amount of investment being considered. This results in, *ceteris paribus*, larger deals being preferred;
* As the time-to-exit on average increases[[21]](#footnote-22), particularly for high tech and life science companies (for example one investor interviewed had one investment that had been first funded 13 years ago), this means that there may be a reluctance to make such long-term investments especially when the risks may be perceived as being high; and
* As fund managers’ remuneration is linked to returns, there was felt to be a tendency to favour larger deals where costs are a lower percentage of the investment. It was also the case that the diligence costs would be proportionally lower.

**3.10** In addition, the interviews for this Review highlighted other factors that influenced the supply of capital:-

* The existence of tax incentives that may have a positive influence on individual investors; and
* Given the risk profile of investments highlighted above (Paragraph 3.2), investors need to have the funds to enable them to do several deals (develop a portfolio) if they are to increase the probability that they will make adequate returns. Therefore, smaller investors may be unwilling to invest in the absence of public support that will enable their money to go further into more deals and therefore enhance the chances of making respectable returns.

**3.11** Clearly some of these factors outlined above (for example information) are classic market failures. Others are more market features, albeit they may bring outcomes that are economically and politically unacceptable.

**3.12** The same evaluation report looked at the demand side. Here three issues were identified that were felt to affect the demand for investment. Again, it is felt that these are still valid:-

* Information failures, with companies being unclear as to how to go about securing investment at an acceptable cost. The interviews for this Review found that this was still an issue. The extent to which companies are unable to find the “right” investors might equally reflect the nature of the company, including its viability, or an inability to agree acceptable terms. However, the interviewees felt it reflected the difficulties, articulated earlier, that Scottish based companies experienced in attracting substantial funding when most of the funders were based outside of Scotland;
* An inability of companies to articulate a compelling vision for investment when approaching funders. This has been recognised by SIB with additional resources being put into Financial Readiness support, help preparing “teaser” documents and “pitch training”, albeit some investors interviewed felt that this was still an issue; and
* A reluctance by some companies to accept external equity as this would mean losing an element of control. Interestingly one interviewee felt that the involvement of SIB to some extent overcame this reluctance as it was felt to be less aggressive and interventionist than private sector investors and could act as a counterbalance to them.

Again, these would seem to be a mixture of market failures (information) and features.

**The Funding Gap**

**3.13** Underpinning most debates about public sector investment is the existence of a “funding gap”, that is a specific amount of investment, often defined by lower and upper limits, where sound companies (subject to the above outline of risk (Paragraph 3.2)) find it hard, if not impossible, to raise capital. Clearly any “gap” is unlikely to be arithmetically exact, given that all investment asks are likely to be unique, but more a general indication of the amounts of funding where difficulties are experienced.

**3.14** When the Funds were established they were to fill what was seen to be a gap in the provision of “*adequate and appropriate*”[[22]](#footnote-23) amounts of venture capital to support innovative companies with growth potential. The original “gap” was said by interviewees to be up to £2 million. The consensus now was that the work of SIB and LINC[[23]](#footnote-24) had meant that there was now no shortage of funding at this level (LINC provides advice for angel syndicates and not funding). However, it was stressed that this was not to say that the funding gap no longer existed. Without the comfort and funding that SIB provided it was felt that, were it to withdraw from the market, then the supply of capital would begin to decrease as the angels were unwilling, and perhaps unable, to take all the investment risk. Thus, the activities of SIB have “filled” the original funding gap although the nature of the market means that their continuing involvement is essential if the supply of capital is not to dry up. Indeed, the intrinsic high-risk nature of the market would seem to imply that public sector support is an ongoing requirement and that the “gap” may change but is unlikely to be totally filled by the private sector.

**3.15** It was now felt that the “new” gap was in the region of £2 to £10 million. Indeed, it was in recognition of the changed nature of this gap that the Funds’ parameters were widened and made more flexible (Paragraph 2. 2). This gap was felt not to be sufficiently attractive to Venture Capitalists and, although some angel syndicates were in this market, for most this was beyond their resources and appetite for risk. The view of one experienced syndicate manager was that, consequently, there were companies in Scotland that had considerable potential but were unable to realise this due to lack of capital. There was then a danger that this could become a self-fulfilling prophesy as companies’ management had to spend considerable amounts of time fund raising, potentially to the detriment of the development of the business.

**Conclusions**

**3.16** Drawing together the various strands of evidence, the views of the various interviewees are that there is a range of complementary support that has increased the supply of risk capital in Scotland. This support has:-

* Stimulated the growth of angel syndicates across Scotland. Indeed, this was cited by several interviewees as one of the key achievements. These have then been able, in partnership with SIB, to increase the flow of investment to early stage and growth companies. As one commented *“There would be no syndicate without SIB”*. It was felt that the creation of a vibrant angel community was looked on with envy from other parts of the United Kingdom; and
* Resulted in the original funding gap (of below £1 million) being adequately catered for by angel and other investors’ activities and complementary support from the public sector. However, this is not to say that the gap is “filled” and that public sector support is no longer required. These types of early stage investments are still felt to be high risk and public sector support is still needed if private sector money is to be invested. Without SIB’s ability to share the risk, it was felt that there would be far less private sector investment, fewer deals and more early stage companies that would find it difficult, if not impossible, to raise capital.

3.17 There was, however, felt to now be a new gap of £2 million and above. This to some extent reflects the limited number of Venture Capital companies in Scotland, despite the efforts of SIB to stimulate this market. For many of the angel syndicates this level of funding was beyond their resources as well as exposing them to levels of risk that were, perhaps, unacceptably high. At this level, the number of deals is likely to be fewer. However, there is also less public sector funding.

**4.** **The Funds – Their Delivery and Effectiveness**

**4.1** This Section of the review draws together and synthesises the views and opinions of the various interviewees. The starting point is to give a general overview of SIB and the two Funds.

**Overview**

**4.2** Overall levels of satisfaction with SIB and the Funds were very high. It was felt that, in the words of one interviewee:-

*“SIB has been instrumental in developing a well-functioning financial ecosystem in Scotland especially in the £0 to £2 million area”.*

It was difficult to find capital for start-ups at this level and SIB had been successful at, not only providing additional capital to help to fill the funding gap, but in levering additional investors into this market for the benefit of the wider economy. For example, one company said that although only 8% of its funding had come through SIB this had provided a *“foundation*” for other investors, even though SIB was not the lead investor. It was felt that there was now a reasonable amount of capital at this level, especially in the Central Belt, albeit companies in other parts of Scotland might still find it difficult to raise money. This is not a criticism of SIB, given that its role is to follow the lead of the private sector investors. However, these difficulties in raising capital are recognised by SIB and it has been working on how to overcome them.

**4.3** Having SIB as an investor was seen as giving the company a degree of credibility with other investors (*“a badge*”) at both the initial investment stage (given that investments are increasingly syndicated) and when seeking follow-on so that others were then more likely to invest. As one commented:-

*“SIB is a really effective way of getting other investors interested”.*

**4.4** The diligence undertaken for the Venture Fund was seen as part of this “accreditation” both for the lead investor and for others who may get involved in the deal, as this investor’s comment makes clear when referring to follow-on investment:-

“*If SIB thought the project was good then that is good enough for us”.*

**4.5** There was recognition that, although investment was critical, the other support that companies could receive through SE and HIE was very significant in ensuring that predicted growth was achieved. Account Management was singled out for praise on several occasions, with individual Account Managers often being mentioned by name.

**4.6** Investment through the Funds had, in several instances, been crucial to the development and growth of the investees. For example:-

* One company felt that SIB’s investments had levered in other money so that the company had been able to grow and was now profitable. Without SIB’s support, it would have taken far longer to reach its current turnover levels and there was a strong probability that the company might have gone into administration;
* Another felt that the company would not have started without SIB’s support as the private sector, on its own, was not willing to fund life science start-ups; and
* Another company felt that without SIB it would have had to attempt to raise capital in London and this might have resulted in the company relocating. There was also a risk that this might have taken longer and therefore put the company at risk.

There is therefore clear evidence of additionality, both time and absolute, so that SIB is making things happen that would otherwise not occur.

**4.7** However, interviewees felt there were a number of issues:

In terms of the Funds, there was concern from some stakeholders that too great a proportion of SIB’s investment was going into follow-on investment rather than supporting new companies, albeit this view assumes that there is unsatisfied demand from businesses with viable investment propositions which there is no evidence for.

The perception was that in some instances SIB followed-on to avoid dilution, protecting its position rather than because of a continued funding gap. There was feedback (from investors and investees) that SIB’s support at times was not always needed: the investment may in some cases have been sourced from the private sector. It was beyond the scope of this Review to assess the extent to which alternative sources of funding were a viable option, for example it may be that those who felt that alternative sources of investment were possible may be underestimating the difficulties and costs of doing this. Those expressing this view were not saying that follow-on should not be done as there was recognition that in a company’s early stages it was often vital, with SIB’s involvement giving confidence to other investors. As outlined earlier (Paragraph 1.3) the Funds operate under the Market Economy Operator Principle (MEOP) and so are required to operate on a commercial basis under State Aid guidelines. This means that whilst SIB will only invest into a company for the first time where there is an identified funding gap, it requires to act in a commercial manner when establishing the need for further, follow on investment. This means that the Funds are required to further invest into a company (alongside partners) if there is a commercial case, even if other investors may be willing to fill any gap. Better communications about this to partners and stakeholders may be needed;

* Some of those expressing concerns about this linked these to the perceived need to have a clear exit strategy and their view that there should be more rigorous “w*eeding*” of the portfolio, it being felt that too many investments were not performing especially well and could be offloaded (albeit this was not a view for which evidence could be cited). It is also accepted that there may be a reputational risk of doing this, especially if the co-investors continue to provide support, as well as potential political pressure not to exit; and
* In terms of the wider investment community there were two areas of concern noted:-
	+ The limited capacity that some angel syndicates had both to provide investment (new and follow-on) and to facilitate company growth. Some felt that these syndicates tended to want to control the companies they invested in, something that was not necessarily in the companies’ best long term interests; and
	+ The lack of *a “critical mass of investors”* in Scotland. Although it was recognised that SIB and LINC had been very effective in growing the angel community and there were now several Venture Companies in Scotland (for example Maven, Panoramic and Epidarex), it was felt that there were still not enough. For investments beyond a level generally said to be £2 to £10 million (although some put the lower limit higher), companies had to go to London. This view was not universal. One investor said that VCs regularly trawled Scotland looking for opportunities whilst another felt that a good idea linked to a sound management team would always secure funding. However, these were minority views.

**4.8** Many investors and investees had wide experience of the United Kingdom and other investment markets. The consensus was that the Scottish co-investment model worked exceptionally well, levering additional resources and investors into the market as well as providing gap funding. SIB was felt to be far more pro-active than other public sector investment banks and the link to the wider services provided by SE and HIE meant that holistic support was available to investees. This was seen as being unique in the UK, with companies being able to access grants, investment and wider business support.

**4.9** Underpinning this model was the quality of the staff, both in SIB and elsewhere within SE and HIE. There was strong praise for the SIB Transaction Staff. There was less available feedback for the Portfolio Specialists as some interviewees had had limited contact reflecting the differential role of the Specialists who, given the volume portfolio, are more “hands-off” when companies are performing well. Those that had experienced support were very positive. Account Managers also came in for strong praise.

**4.10** The issues outlined above are explored in greater detail below.

**The Angel Syndicates**

**4.11** One of the key achievements of SIB alongside LINC has been to increase the number of angels and angel syndicates that are active in the Scottish market (Paragraph 3.14). Feedback was that the syndicates varied considerably in the amount of money the members have to invest and the professionalism with which they approached investment:-

* At one extreme are the relatively small syndicates many of whose members are not very active and who invest relatively small amounts of money. There could sometimes be a reluctance from the members to see the investees receive investment from others as this would dilute their stake and potential returns. However, these syndicates could lack the resources to provide the companies with the investment they needed to grow. Indeed, these limited amounts of finance have been responsible for some syndicates being no longer SCF accredited partners. It was also felt by some investors that one of the key drivers for individual syndicate members was tax benefits rather than a desire to see the companies in which they had invested grow. At times, this approach caused frustration to some syndicate managers who would like the investors to be more pro-active. Whilst all these actions are understandable they may not be in the best interests of the investees who may be undercapitalised and spend a disproportionate amount of management time raising relatively small amounts of funding in multiple rounds. It may also be that some companies do not raise sufficient money at the start and are then reluctant to put the time and effort in to raising more external funds. SIB is currently finding difficulties getting engagement from companies to participate in initial sessions for Scottish-European Growth Co-Investment Programme[[24]](#footnote-25) which are about raising awareness and introducing them to new investors. The difficulties in changing these behaviours and cultures are not underestimated. It is also the case that there have been changes to SCF’s partner accreditation processes, after the 2015 re-approval[[25]](#footnote-26), so that there is greater confidence that new partners can add value, provide the needed levels of follow-on support and have objectives that are aligned to SIBs; and
* At the other extreme are the larger syndicates that can invest substantial amounts into companies that they feel have growth potential. Whilst they too may be unhappy to see additional investments that may dilute their stake, the amount of money they can invest (either initially or in follow-on) would seem to ensure that companies are able to get the funding they need. In the words of one investor: *“We want the managers in the companies in which we invest to grow the companies, not to spend time on hand-to-mouth fundraising*”.

**4.12** If the new “gap” is £2 million and upwards then one way of potentially filling this may be to try to develop more angel syndicates (potentially through consolidation) that have the resources, willingness and patience to make such investments and then stay with them until they can exit at a profit. Interviewees made the point that angels with capability not just capacity were required. It was felt that there were not enough with the drive which would see them take an active role in their investments. This was summarised by one interviewee who stated that Scotland needed more angels who were willing to get involved and support companies.

**4.13** This seems unlikely to be something that will be easy to do, given what has already been pointed out about the spatial distribution of wealth across the various geographies of the United Kingdom (see Paragraphs 3.4 to 3.6). However, were it possible, then the economic development benefits would seem to be considerable. One other suggestion was to encourage the smaller syndicates to merge even though some considered that this was unlikely to happen. SIB is planning to undertake research on the future of Angel investment in Scotland.

**Attracting Other Investors**

**4.14** There was a general acknowledgement that the investment community in Scotland was small, especially for investors able to provide capital upwards of £2 million, albeit that one interviewee felt that these difficulties were exaggerated as at this level the company should be “*a business of scale and had a story to tell”* so investment should be forthcoming. Others felt that it was misleading to generalise as the size of funding required was not always correlated with the company’s development stage.

**4.15** As has been shown earlier (Paragraph 3.5) very few large investors are based in Scotland. To what extent this is a chicken and egg situation is hard to know: large investors are not here as there are too few opportunities or the opportunities are not here as there is not a large enough investment community to fund them. However, as Paragraph 3.5 shows, of the 77 investors, 5% have a Scottish presence. This is below Scotland’s share of UK population (8%).

**4.16** Attempts have been made to attract more investors to Scotland (most recently through the establishment of the SEGCP with the European Investment Fund). This is a medium to longer term solution and there is still a desire to increase the size of the Scottish investment community. One suggestion was that SIB should facilitate visits of potential investees to investor hubs where they could meet (and pitch to) investors with an interest in their sector and expertise.

**4.17** SE has explored options for attracting international investors and has concluded that London should be the immediate target given both its proximity to Scotland and the amount of investment capital that is based in, or invested through, London. Increased engagement has begun, working through the recently established Innovation and Investment Hub.

**Follow-on Investments**

 **4.18** The earlier analysis (Paragraph 2.13) has shown that a large proportion of money is being used for follow-on investments: that is making additional investments in companies that are already in the portfolio. The trend towards increased investment was something that has been commented upon in earlier evaluations and is in line with wider market trends. For example, the evaluation of SCF II[[26]](#footnote-27) reported that in 2009 11% of investments were in follow-on and that this had risen to 40% by the end of 2013. As the evaluation said:-

“*Whilst it might be expected that follow-on deals would form a greater proportion of SCFII investments as the Fund matured, this analysis does demonstrate the potential impact of commitments to follow-on on the capacity of the Fund to make new investments in the latter half of the evaluation period”.*

**4.19** The report goes on to state that:-

*‘’However, for this potential impact to have an effect it would require there to be unsatisfied demand for new investment from new businesses with viable investment propositions.’’*

There is no evidence from market reports that this is the case. For example, the overall risk capital market in Scotland[[27]](#footnote-28) has experienced an increase in new companies receiving investment of over 200% (2012 to 2016) compared to an increase of 60% for follow-on investments over the same period. In 2012, some 20% of total deals were for new companies: by 2016 this had increased to 35%. However, the increase in levels of investment proved less dramatic with amounts invested in new companies increasing minimally from 13% in 2012 to 16% in 2016.

**4.20** The extent of follow-on by SIB is very similar to the wider market. This is illustrated in Tables 4.1 and 4.2. that show that in Scotland between 2012 and 2016:-

* 82% of investment went into follow-on; and
* This accounted for 72% of all deals over this time.

**TABLE 4.1 Investment Split: New Deals and Follow-On By Value -Scotland (£m)**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **A** | **B** | **C** | **D** | **E** |
| **Year** | **New Investment** | **Follow-on Investment** | **Total** | **Follow-on as a percentage of total**(C/D x 100) |
| 2012 | £18 | £123 | £141 | 87% |
| 2013 | £63 | £152 | £215 | 71% |
| 2014 | £40 | £224 | £264 | 85% |
| 2015 | £78 | £394 | £472 | 84% |
| 2016 | £53 | £283 | £336 | 84% |
| **TOTAL** | **£252** | **£1,176** | **£1,428** | **82%** |

**Source:** Scottish Investment Bank

**TABLE 4.2 Investment Split: New Deals and Follow-On By Number of Deals -Scotland**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **A** | **B** | **C** | **D** | **E** |
| **Year** | **New Investment** | **Follow-on Investment** | **Total** | **Follow-on as a percentage of total**(C/D x 100) |
| 2012 | 32 | 117 | 149 | 79% |
| 2013 | 43 | 106 | 149 | 71% |
| 2014 | 55 | 169 | 224 | 75% |
| 2015 | 60 | 162 | 222 | 73% |
| 2016 | 101 | 184 | 285 | 65% |
| **TOTAL** | **291** | **738** | **1,029** | **72%** |

**Source:** Scottish Investment Bank

**4.21** Although there is a degree of volatility in the figures they are generally quite consistent in showing that over 70% of money and two thirds of deals involved follow-on. The comparable figures for SCF and SVF III (Paragraph 2.13) are 60% of investment and 66% of companies were follow-ons. It is therefore clear that SIB’s investment pattern is mirroring closely the wider Scottish market.

**4.22** Follow-on was discussed with many of the interviewees. Views varied:-

* Many felt that this was an understandable response by any investor, in that there was a reluctance to see initial investments diluted. As a public sector body, it was felt that this was a way of protecting public funds and was therefore good stewardship;
* However, several of these interviewees (investors and investees) felt that sometimes SIB support was not necessary for later rounds where a company had a track record and was then attractive to external investors, and should only follow-on when it was difficult to attract other investors. This was not to argue that follow-on should not be done as clearly there are many instances where investees require additional support to realise their growth plans.

**4.23** From an economic development perspective once the private sector is willing to provide the necessary investment, then SIB not providing further investment will not have any adverse economic development effects. In effect SIB’s involvement has resulted in the specific market failure being rectified, so it could place resources elsewhere and not dilute the economic impact of the investment. Continued investment, when all the follow-on can be provided by the private sector, may mean that the economic development benefits are diluted as SIB’s involvement creates deadweight. The justification for continued investment, as mentioned earlier (Paragraph 4.7), is that follow-on needs to be done to ensure that SIB is MEOP compliant and is operating commercially and optimising returns to the public purse.

**4.24** Related to this was the concern expressed by some stakeholders about the size of the investment portfolio. The rhetorical question, asked by one, was: *“Are we investing in too many companies that aren’t giving us the right economic returns? Are we placing too much emphasis upon quantity rather than quality”?* However, it is accepted that this is an issue for *the* partners who introduce these eligible investment opportunities to SIB.

**4.25** One reason for the size of the portfolio is time taken to exit has grown in recent years. One investor felt that this was now from 5 to 15 years (one investment had been held for 13 years whilst it was also now felt that the norm for Life Sciences companies was more than 10 years). However, from an economic development perspective the importance of the availability of capital over an extended period, in sufficient quantities of new and follow-on investment, is considered critical to creating more successful companies that can scale and operate in international markets.

**An Exit Strategy**

**4.26** Several interviewees raised SIB’s exit strategy not being clear as an issue. Some stakeholders felt if there were more exits then resources could be channelled into new investments that might have greater economic development potential. However, as noted above, there is no evidence from evaluations, risk market analysis and consultations that new viable propositions are unable to secure funding. The earlier evidence as to the performance of investments through the Funds (Table 2.3) would seem to support this view.

**Complementary Support**

**4.27** A common thread linking most interviews was the importance of the additional support that SE could provide to investee companies. This is a theme that has emerged in earlier evaluations, for example that of the Scottish Venture Fund[[28]](#footnote-29), when commenting upon the Fund’s impacts, stated that:-

*“However, it is important to stress at the outset that these are impacts for which the SVF investments were* ***necessary, but not sufficient.*** *The investments are necessary in that without them the impacts would not occur, but they are not sufficient, in that other factors in the past, present and future are also likely to be necessary for the impacts to occur, for example, the economic context and other SE support”.*

**4.28** What came through very strongly in the interviews was the importance of the Account Management process, something cited by almost all the company interviewees and many of the investors, not just as a way of identifying suitable types of support, but the ongoing advice and guidance that Account Managers and others were able to provide. Two quotations illustrate this:-

“*She* (the Account Manager*) did an absolutely first class and outstanding job in supporting the whole team”;* and

*“The Account Manager has been absolutely fantastic. Faultless in our view”.*

**4.29** One investor, with wide experience across the United Kingdom, felt that the support infrastructure in Scotland was unique. Not only was finance available but also a wide range of hard and soft business support. Whilst other parts of the UK could provide financial support, rarely was it possible to access the comprehensive support package that was available in Scotland. This would seem to be a key finding that may underpin some of Scotland’s success in such areas as winning inward investment

**4.30** If there was a concern, it was that attempts might be made to separate the various parts of the support package, for example if SIB were no longer to be a part of SE. This was felt to be something that would be very detrimental.

**Investment Certainty**

**4.31** One of the main advantages of being a Co-Investment partner, cited by several investors, was the certainty that the process gave. SIB was described by one as “*a passive investor*”. If the investor wanted to put money into a company then the SIB contribution was likely to be forthcoming. It was argued that this model should be extended to the Venture Fund where it was felt there were more hurdles and uncertainty. It should be noted, however, that investors are free to apply to become an accredited partner and utilise the SCF.

**4.32** Several interviewees were concerned that this certainty might be eroded as SIB’s Investment Committee began to play more of a role, through the Transaction Introduction Paper (TIP, Paragraph 2.7). For example, one investor was concerned that the plans of one of its investees (to manufacture in China) might result in SIB being reluctant to make future investments, given that the economic development benefits of such a move would have limited impact in Scotland. The TIP was introduced by SIB to manage budget allocations rather than to appraise potential investments, and therefore it may be that more could be done to reassure investors and explain the purpose of the TIP.

**Board Representation**

**4.33** In the deals it is involved in, SIB will normally have the right to appoint a board observer or non-executive board member. Generally, this had been welcomed by interviews as it was felt to introduce new skills sets and experience to the board and make the whole approach more professional. It was also felt that SIB’s nominees often provided a counterbalance to some of the more aggressive stances that could be taken by other investors, which might not always be to the longer-term benefit of the company.

**4.34** However, it was felt that more could be done by SIB, in particular:-

* Looking for greater diversity amongst those recommended as non-executive directors, albeit that this is something that SIB has been working on; and
* Ensure that SIB had representation on the boards of all companies in which it had invested.

**4.35** A view shared by several interviewees was that there is limited external talent in Scotland to be deployed on company boards. However, except for one interviewee who felt more use should be made of GlobalScots[[29]](#footnote-30) to identify suitable candidates, no one was able to suggest what could be done about this. SIB does engage with GlobalScots and has put several candidates forward for positions but, as many are based overseas, this may limit the time they can devote to Scottish companies. However, potentially more could be done to make use of their insights and networks.

**Process**

**4.36** There was a feeling amongst some interviewees that the process of doing deals with SIB (through the Venture Fund) felt more onerous than with other investors. The areas mentioned were:-

* The amount of paperwork, with the amount required for follow-on deals being felt to be unnecessary, especially when compared to what was asked for by other investors;
* This could lead to more legal fees than otherwise might be the case;
* The approval timetable which it was felt could be lengthy, albeit that others commented that their experience had been that the timetables were invariably kept to and therefore provided certainty;
* Less flexibility in changing deal conditions than other investors, especially when making follow-on investments. This however doesn’t appear to recognise the fact that in the vast majority of cases the terms and conditions mirror those of private sector co-inventors.

**4.37** However, in discussion it emerged that these concerns were minor and were understood by the interviewees given that SIB was spending public money and, as such, due process needed to be followed. And in many cases SIB was essentially acting no differently to any other arms-length investor.

**4.38** The need for diligence was highlighted as a positive. Not only did it result in the company’s ideas being subject to independent scrutiny but, as mentioned above (Paragraph 4.4), it was seen as being an attractor to other investors.

**Partner Relationships**

**4.39** The small number of investors with experience of both Funds felt that the SCF model should be followed by the Venture Fund: accredited partners whose lead was then followed by SIB. This was articulated in terms of there then being no need for SIB to undertake diligence. This contradicts the views expressed earlier about SIB’s due diligence acting as seal of approval for other investors (Paragraphs 4.3 and 4.4). There appears to be the need for improved communications in so far as investors could apply to become accredited SCF partners to benefit from the streamlined model afforded to these partners.

**4.40** It was also felt that a greater investment role should be given to SIB specialists; they know the company and staff and as such were in a better position to make judgements than a more remote Investment Committee. However, as the specialists present the case to the Investment Committee this view may be based upon misunderstandings of the process.

**Conclusions**

**4.41** The main finding from the various interviews was that the two Funds had been very effective in providing investment capital that would otherwise not have been available. As such they seem to be meeting their key objectives of providing capital to new-start and growth technology companies, that would otherwise find it difficult to raise finance, and stimulating the base of active investors in Scotland. The comments synthesised above need to be seen in this wider context of an intervention that is meeting its objectives and which is well thought of by all parties.

**5. The Economic Impact of the Funds**

**5.1** In assessing the likely economic impacts of the two Funds use has been made of:-

* Recent evaluation evidence; and
* The qualitative interviews with investors and investees.

**5.2** Ideally a survey of beneficiaries would have been undertaken to inform this Review, collecting quantitative information through company interviews. However, this was not possible given the time available. Accordingly, the sources identified above have been used.

**The Evaluations**

**5.3.** The SVF[[30]](#footnote-31) and SCF[[31]](#footnote-32) have been evaluated relatively recently:-

* The SVF evaluation was commissioned in January 2011 and covered the period from the first investment (March 2007) until the end of 2010; and
* The SCF evaluation (undertaken in the period December 2014 to March 2015) covered investments made between April 2009 and December 2013. It was felt that investments made after December 2013 were likely to be too recent to have had any quantitative impact upon company performance.

**The Evaluation Evidence**

**5.4** The SVF evaluation concluded that *“SVF has brought positive benefits to the Scottish economy”*. In terms of net economic impacts (that is after making the usual additionality adjustments):-

* It was estimated that to date around jobs had been created which were forecast to increase to 790 over 10 years. Thus, the to-date employment impact represents 40% of the 10-year total;
* Cumulative GVA to date was negative, reflecting the fact that many investees were early stage companies that were at the start of their development. However, it was expected that cumulative GVA would be £253 million over 10 years; and
* The relative impact metrics indicated that to date the Cost per Job was £134,000. Over 10 years this was expected to fall to £54,000[[32]](#footnote-33). The Impact Ratio (net GVA per £1 SE/SIB support) was estimated to be 6:1 over 10 years[[33]](#footnote-34).

**5.5** In addition several other benefits were highlighted as a result of SIB support:-

* Increased spend on R & D and innovation, for example 90% of interviewees had, or intended to, increase spend on R & D, perhaps with additional SE support; and
* Increases to productivity and exports.

Most of these benefits were claimed to be additional: without SVF support they would not have come about.

**5.6** The report also highlighted something that permeates this Review: the linkages and dependencies with other SE support. For example, 63% of the interviewees had received advice or support in addition to finance. The importance of this complementary support was such that one of the few Recommendations from the Evaluation was that this relationship should be strengthened.

**5.7** The evaluation of the Co-Investment Fund (published in 2017, although looking at the Fund’s impact over an earlier period), reported that the Fund had:-

 *“The potential to generate significant economic impact at the Scottish and UK levels”* (p. 5).

**5.8** In terms of the net quantitative impacts:-

* To date (2015) £31 million of GVA had been created. Over 10 years the estimate was that this would increase to £290 million. Thus, to date 11% of forecast GVA had been created;
* The Impact Ratio was estimated to be 2:1 in 2015 increasing to 14:1 over ten years;
* Net additional employment in the sample was estimated to be 240 Full Time Equivalents in 2015, rising to a peak of 660 based on projections to 2025. The to-date impact is therefore 36% of the forecast 10-year total; and
* Although not reported in the Evaluation, it is possible to calculate the Cost per Job. To date this was £87,000 falling to £32,000 over 10 years.

**5.9** What the two evaluations therefore show is that:-

* The impacts to date were generally a relatively small percentage of those forecast over a medium 10-year time horizon. This was especially the case for GVA, which for the Venture Fund was negative to date whilst for SCF just over a tenth of forecast GVA had been created;
* The employment impacts to date were more positive with, for both Funds, over a third of forecast jobs having been achieved to date;
* Not surprisingly the Impact Ratios to date, where they existed, were small, although the medium-term forecasts were more positive (less so for the Venture Fund); and
* The Cost per Job was high, even when the forecast employment figures were used. However, this needs to be set within the context of the types of firms being supported (see Tables 2.4 and 2.5 which show an emphasis on what seem likely to be capital intensive companies involved in Enabling Technologies and Life Sciences).

**Deadweight**

**5.10.** One of the key additionality adjustments when moving from gross to net impacts is deadweight: the extent to which the benefits arising from public sector support have come about regardless. Is there, therefore, any evidence of deadweight in the operations of the Funds? That is, if SIB did not invest in companies, would they be able to raise the necessary capital from the private sector?

**5.11** Clearly given that a proportion of investments fail regardless of the extent of diligence (Paragraph 3.2), this is something that ideally needs to be considered on a portfolio basis, albeit it may be influenced by the stage in the funding cycle that the company is at:-

* For early stage investments (both initial and follow-on) it is clear (based on the feedback from investors and companies) that without SIB the number of investment deals would be far fewer. The start-up pre-revenue market is high risk and SIB’s involvement enables investors to share the risks by limiting their exposure. At least two of the companies interviewed felt that without SIB the company would not have either started or would not have been able to continue. Given this, there is evidence of economic additionality that SIB’s involvement, through the Funds, is responsible for; and
* When follow-on funding is considered the picture is less clear at the point where investees are demonstrating a track record. There was feedback from both investors and investees that in some follow-on rounds that SIB had participated in, it may have been possible to raise the capital from other private sector sources, albeit that the challenges of securing such funding may be underestimated.

**5.12** It therefore seems that in later funding rounds there may be some potential for deadweight albeit this is a consequence of the Funds having to be MEOP compliant (Paragraph 4.7).

**5.13** Based on the feedback from interviewees, therefore, some follow-on may not always be needed from SCF or SVF as the private sector may have provided it, albeit this affects a relatively small number of investments. Given that this is qualitative rather than quantitative evidence, it is not possible to provide a definitive numerical estimate of deadweight.

**The Impacts of Phase III of the Funds - GVA**

**5.14** Table 5.1 applies the GVA Impact Ratio from the two evaluations to the amount invested to date through SCF III and SVF III. This enables the estimated net GVA to be calculated based on the assumption that the conditions relevant at the time the evaluations were undertaken were similar over the period that the Phase III investments were made.

**TABLE 5.1 Estimated Net GVA (July 2015 to June 2025)**

 (Before deadweight and time to exit adjustments)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Fund** | **Amount Invested by SIB (£ m)** | **Impact Ratio to date****(September 2017)** | **Net GVA to date (£ m)****(September 2017)** | **Ten-year Impact Ratio****(July 2015 to June 2025** | **Net GVA ten years (£ m)****(July 2015 to June 2025** |
| **SCF III** | £24.470 | 2:1 | £48.940 | 14:1 | £342.580 |
| **SVF III** | £43.305 | 0:1 | £0.000 | 6:1 | £259.830 |
| **TOTAL** | **£67.775** | **N/A** | **£48.940** | **N/A** | **£602.410** |

**Note:-**

**1.** Eight companies received both SCF and SVF investment during Phase III

**5.15** There is feedback that would justify two further adjustments being made:-

* An adjustment for deadweight to account for the fact that a small proportion of follow-on investments made by SIB could have been made by the private sector (Paragraphs 5.10 to 5.13); and
* An adjustment to take account of the fact that the time to exit has got longer since the evaluations were completed. This would seem to reflect changed economic circumstances. From an economic impact point of view this seems likely to delay the creation of the GVA impacts so that the net GVA at year 10 will be lower than anticipated by the earlier evaluations.

**5.16** Any adjustments made must be notional in so far there is no definitive evidence on which to base them. Accordingly, a 10% adjustment has been made for deadweight and 20% for the additional time to exit. These adjustments are in addition to those made in the original evaluations as they are felt to reflect different factors that neither evaluation took account of. The adjustments have been made to the net impacts in Table 5.1. Table 5.2 shows the estimated net GVA after these two adjustments. The 10 year Impact Ratios fall to:-

* 10:1 for the Co-Investment Fund;
* 4:1 for the Venture Fund; and
* 6:1 for the 2 Funds combined.

**TABLE 5.2 Estimated Net GVA (July 2015 to June 2025)**

 (After deadweight and time to exit adjustments)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Fund** | **Net GVA to date (£ m)****(September 2017)** | **10% Deadweight and 20% time to exit adjustments****(£ m)** | **Net GVA ten years (£ m)****(July 2015 to June 2025)** | **10% Deadweight and 20%time to exit adjustments****(£ m)** | **Ten year Impact Ratio****(July 2015 to June 2025)** |
| **SCF III** | £49 | £31  | £343 | £247 | 10:1 |
| **SVF III** | £0  | £0  | £260 | £187 | 4:1 |
| **TOTAL** | **£49** | **£31** | **£603** | **£434** | **6:1** |

**Note:-**

**1.** Eight companies received both SCF and SVF investment during Phase III

**The Impacts of Phase III of the Funds - Employment**

**5.17** To calculate the net employment impacts of the Funds:-

* The net Cost per Job to-date and at 10 years was taken and divided into the total SIB spend through each of the Funds; and
* The number of jobs was then adjusted by applying the 10% deadweight and the 20% time to exit adjustments.

**5.18** Table 5.3 shows the estimated employment impacts before the adjustments were made: 600 jobs to date and 1,600 at Year 10 for the combined Funds, with both Funds being responsible for similar numbers of jobs. It is not obvious why the jobs impacts of the two Funds are similar whilst GVA impacts differ, with the SCF Impact Ratio being double that of the Venture Fund.

**TABLE 5.3 Estimated Net Employment Impacts**

 (Before deadweight and time to exit adjustments)

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Fund** | **Amount Invested by SIB (£ m)** | **Cost per job to date****(September 2017)** | **Net jobs to date****(September 2017)** | **Cost per job at Ten years****(June 2025)** | **Net jobs at ten years****(June 2025)** |
| **SCF III** | £24.470 | £87,000 | 281 | £32,000 | 765 |
| **SVF III** | £43.305 | £134,000 | 323 | £54,000 | 802 |
| **TOTAL** | **£67.775** | **N/A** | **604** | **N/A** | **1,567** |

**Note:-**

**1.** Eight companies received both SCF and SVF investment during Phase III

**5.19** Table 5.4 looks at the estimated employment impacts after making the adjustments. The Costs per Job, to date, are high. However, over 10 years they fall to an average for the two Funds of £60,000. The point has already been made (Paragraph 5.9) that the Cost per Job figures need to be interpreted within the context of the type of companies that are being supported: ones involved in Enabling Technologies and Life Sciences which are likely to be capital intensive and need staff who are highly skilled and qualified. Given this, it is perhaps not wise to read too much into these figures.

**TABLE 5.4 Estimated Net Employment Impacts**

 (After deadweight and time to exit adjustments)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Fund** | **Net jobs to date** | **Net jobs after10% Deadweight and 20% time to exit adjustments**  | **Cost per Job to date**  |  **Net jobs at ten years**  |  **Net jobs after10% Deadweight and 20% time to exit adjustments**  | **Cost per job at Ten years**  |
| **SCF III** | 281 | 202 |  £121,000 | 765  |  551 | £44,000 |
| **SVF III** | 323 |  233 | £186,000  | 802  |  577 | £75,000 |
| **TOTAL** | **604** |  **435** | **£156,000**  | **1,567** |  **1,128** | **£60,000** |

**Note:-**

**1.** Eight companies received both SCF and SVF investment during Phase III

**Conclusions**

**5.20** Estimating the quantitative impacts has had to draw upon earlier evaluations, undertaken at a time when economic conditions were different. Some adjustments have been made to reflect these, in particular the longer time now needed before investments can be exited and an adjustment to reflect the evidence that may be deadweight in some follow-on investments (see Paragraph 5.11, Final bullet point).

**5.21** The impacts “to date” are, in common with the findings from other evaluations undertaken of SE’s investment activities, relatively low, although this is not unexpected given the early stage of many of the investees. Over 10 years the potential GVA Impact Ratio is respectable, whilst the Cost Per job, although high, must be seen in the context of the type of high value jobs that are being created. It seems likely that the other outcomes identified by the earlier evaluations will also have arisen: for example, additional spend on innovation and R & D, and increased exports. It is also the case that when returns are made then the investments costs will fall so that the relative impact metrics should improve: that is the Impact Ratio will increase whilst the Cost per Job will fall.

**6. Conclusions and Recommendations**

**Conclusions**

**6.1** The general view of both Funds was that they were very effective. As one investor said “*SIB/SCF is a model that works and there is no need for change”.* The Funds managed by SIB, along with the wider activities of SIB and LINC to stimulate the market, had resulted in a degree of risk mitigation so that there was now more investment capital in the early stage market. It was now felt that for investments below £1 million there was an adequate supply of capital. Despite this, interviewees stressed that this did not mean that SIB could, or should, withdraw from this market. Regardless of public sector activity, this would remain an inherently risky area where public sector intervention would, for the foreseeable future, be needed.

**6.2** It was now felt that there was a new funding gap emerging of upwards of £2 million. This reflected the relatively few venture capitalists based in Scotland as well as capital at this level being beyond the investment resources of most of the angels and angel syndicates.

**6.3** SIB was felt to have played a significant role (along with LINC) in stimulating the development of angel syndicates so much so that Scotland’s angel investment community was looked on with envy from elsewhere in the UK.

**6.4** The way the Funds were managed and delivered came in for very little criticism. Some interviewees did highlight that the process of doing deals with SIB could be more onerous than with other investors. However, this was accepted by many as inevitable, given the need for those spending public money to ensure that adequate diligence was undertaken.

**6.5** There was some confusion over SIB’s role as an investor and being part of an economic development agency, and therefore following-on its investments even when there may be evidence that in a minority of cases this may not be necessary as others may have filled the gap. Related to this was a view by some of a lack of clarity as to what SIB’s exit strategy from investments was. It may be that increased communication over the MEOP operating model would help to clarify some of these issues.

**6.6** There were other areas where the views and opinions of the interviewees (which included SIB) diverged. Again, this implies that communications are not as effective as they could be, and there is a need for more explicit communication from SIB as to its intentions of, and changes to, practices and procedures.

**6.7** What also emerged very strongly was the complementarity of the total package of assistance that investees could access: finance and also the range of other hard and soft support that was available to Account Managed companies. This is something that has emerged in earlier evaluations and highlights the importance of ensuring that investees become Account Managed if their full economic development potential is to be realised. SIB’s staff were also praised for their professionalism and the support they offered.

**Recommendations**

**6.8** Based on the views of the various interviewees and the Review Team’s analysis, a small number of Recommendations are made:-

* Although the Review was overwhelmingly positive there were some views by interviewees that were based upon misunderstandings about the policy and operating context of the two Funds. Given lack of a consistent understanding of some key aspects it is felt that communications could be more effective. Given this, **Recommendation 1** is that:
* SIB should review its communications strategy with stakeholders, investors and investees and ensute that policy and procedures, and any changes to them, are made explicit;

* There was felt to be a lack of clarity amongst stakeholders as to what SIB’s exit strategy was. **Recommendation 2 is therefore that**:
	+ Consideration should be given to formulating an explicit exit strategy from investments that is communicated to stakeholders as appropriate.
* Although the need to follow-on investments is acknowledged, in a small number of cases some interviewees felt that later stage follow-on was not always needed as the money could potentially be raised from the private sector. **Recommendation 3** is that:
	+ Consideration should be given, when making follow-on decisions and where other private sector funding may be available, to making its operating model (including operating in a commercial basis) clearer to stakeholders, investors and investees.
* Regular evaluations of the Funds have been commissioned and these look at the specific recapitalisation phases of the Funds and not the Funds in their entirety. **Recommendation 4** is that:
	+ Consideration should be given to the potential for assessing performance of the companies invested in through the various Funds since their inception, to ascertain their longer-term impact upon company growth.

**APPENDIX 1**

**LIST OF ERDF RESTRICTED SECTORS**

The restricted sectors are:

(i)            Retail; or

(ii)                  Motor vehicles; or

(iii)                 Real estate/property development; or

(iv)                 Social and personal services; or

(v)                  Pubs, clubs and restaurants; or

(vi)                 Local services; or

(vii)               Banking and insurance; or

(viii)              Nuclear decommissioning; or

(ix)                 Professional services;

1. This was given in February 2018. [↑](#footnote-ref-2)
2. LINC is the national association for business angels in Scotland. [↑](#footnote-ref-3)
3. The SME Holding Fund deploys European Regional Development Fund monies allocated towards financial instruments and is managed by the Scottish Government's Innovation, Investment and Industries Division. [↑](#footnote-ref-4)
4. <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/607691/bis-15-148-state-aid-manual-update.pdf> [↑](#footnote-ref-5)
5. This received Board approval in February 2018 [↑](#footnote-ref-6)
6. <http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=614> [↑](#footnote-ref-7)
7. <http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=614> [↑](#footnote-ref-8)
8. SE and HIE deliver tailored guidance and support to companies that have the potential to make the greatest impact on the Scottish economy through an Account Management process.  Led by an Account Lead, Account Teams are formed to work with companies in a variety of ways to develop and achieve ambitious growth plans. [↑](#footnote-ref-9)
9. A phoenix company is one where the assets of a limited company are moved to another legal entity and some or all the directors remain the same. In some cases, the new entity will have the same or a similar name and will be involved in the same activity as its predecessor. [↑](#footnote-ref-10)
10. <http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=614> [↑](#footnote-ref-11)
11. <http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=512> [↑](#footnote-ref-12)
12. It is likely that leverage ratios will have changed by the end of SVFII [↑](#footnote-ref-13)
13. For example, the [2017 evaluation of the Co-Investment Fund](http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=614) reported that partners expected that or every 10 investments: 1 would produce significant returns, 1 modest returns, 3 to 4 would cover their costs and 4 to 5 would fail. [↑](#footnote-ref-14)
14. <https://www.equalitytrust.org.uk/scale-economic-inequality-uk> For example, the average household in the South East has almost twice (183%) the amount of wealth as the average household in Scotland. [↑](#footnote-ref-15)
15. This is a long-standing phenomenon. For example, [Barclays Wealth in 2011](https://wealth.barclays.com/content/dam/bwpublic/global/documents/wealth_management/2011-UK-Wealth-Map.pdf) reported that in London there were 2.12 millionaires per 1,000 of population compared to 1.34 in Scotland. [↑](#footnote-ref-16)
16. People whose assets (excluding their main residence) are worth more than £750,000. [↑](#footnote-ref-17)
17. <http://entrepreneurhandbook.co.uk/venture-capitalists/> [↑](#footnote-ref-18)
18. <http://www.privateequitymap.co.uk/> [↑](#footnote-ref-19)
19. <http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=512> [↑](#footnote-ref-20)
20. <http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=512> [↑](#footnote-ref-21)
21. The recent economic environment means that it takes longer for companies to grow to the stage when they are attractive to buyers. [↑](#footnote-ref-22)
22. SE Board paper, May 2015 [↑](#footnote-ref-23)
23. <http://lincscot.co.uk/> LINC is the national association for business angels in Scotland. Members include most of the major angel syndicates and individual investors. It plays an important lobbying role with government at all levels and has been instrumental in helping more angel syndicates become established across Scotland, a role it still active in. [↑](#footnote-ref-24)
24. <https://www.scottish-enterprise.com/services/attract-investment/scottish-european-growth-co-investment-programme/scottish-european-growth-co-investment-programme-overview> [↑](#footnote-ref-25)
25. This included the investors’ track record, their experience and information about their portfolios. (see Paragraph 2.7 final bullet point) [↑](#footnote-ref-26)
26. <http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=614>p.29 [↑](#footnote-ref-27)
27. <http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=623> [↑](#footnote-ref-28)
28. <http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=512> [↑](#footnote-ref-29)
29. <https://www.globalscot.com/> [↑](#footnote-ref-30)
30. <http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=512> [↑](#footnote-ref-31)
31. <http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=614> [↑](#footnote-ref-32)
32. This figure is not given in the report but can be calculated. [↑](#footnote-ref-33)
33. It should be noted that the costs do not include staff costs and are the cost of investments made through the Fund alone. [↑](#footnote-ref-34)