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Venture to be wise: UK venture and growth capital

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What's the issue?

The UK government has set out bold ambitions to boost the UK economy. A key part of its plan is to make the UK a more attractive place to run a company, from starting up to publicly listing on a stock exchange. One element of the government's strategy is to increase the supply of capital to this area. The questions are, of course, where this capital comes from and where in the UK financial system it should go.

The government is clear that it wants to see greater investment into the UK's venture and growth capital markets. These are private markets, where companies in their relatively early stages look for financing to ramp up their business, grow their operations and expand into new markets. The theory is that increasing capital to these areas will make the UK a more attractive place for companies to start up. This increased capital can also be seen as a way of improving these companies' chances of succeeding, by helping to support and grow the UK economy.

The aim is to use pension schemes as sources of funding. The government cites the asset class as being complementary to schemes in various ways, including its generally strong long-term performance, which meets schemes' return needs, and the illiquid and long-term nature of the investments, which matches pension schemes' timescales – especially those of open schemes.

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What are venture and growth capital?

This will be the first question for many investors. While investment in the more traditional area of private equity is more common, fewer venture into the smaller, higher-risk end of venture and growth capital.

When investors hear 'venture and growth capital', their first thought is often the TV show, Dragons' Den, where people with a business, or even just a good idea, ask for investment and expertise to help them turn it into a success. However, it's important to note that this is a very small subset of the market, and not where the majority of money goes.

Venture and growth capital covers a wide spectrum of company sizes and stages, up to surprisingly large and established businesses. It can cover those that haven't even earned revenues yet, all the way through to profitable businesses with a proven product or service that want to expand their operations. But in all cases, investments are due to a belief that these are rapidly growing firms with strong return potential. It's important to note that the companies being invested in at the venture and growth capital stage aren't simply looking for money, but the expertise of the investors to help them grow their business.

The British Private Equity & Venture Capital Association (BVCA) defines the different stages of venture capital as:

SEED:
financing that allows a business concept to be developed, perhaps involving the production of a business plan, prototypes and additional research, before bringing a product to market and commencing large-scale manufacturing.

START-UP:
financing provided to companies for use in product development and initial marketing. Companies may be in the process of being set up, or they may have been in business for a short time but haven't yet sold their product commercially.

OTHER EARLY STAGE:
financing for companies that have completed the product development stage but require further funds to initiate commercial manufacturing and sales. They may not yet be generating profits.

LATE-STAGE VENTURE:
financing provided to companies that have reached a fairly stable growth rate ie not growing as fast as in the early stage. These companies may or may not be profitable, but they're more likely to be than in previous stages of development.

EXPANSION:
sometimes known as 'development' or 'growth' capital, provided for the growth and expansion of an operating company that is trading profitably. Capital may be used to finance increased production capacity, or market and product development, or to provide additional working capital.

From this, we can see that growth capital refers to investing in companies at the late end of the venture capital market. These are relatively mature, but they aren't yet able to generate the cash required for major expansions through their day-to-day operations. This capital is typically used to expand or restructure operations, enter new markets, acquire other businesses or restructure finances eg reducing debt.

What's the return profile?

People are often excited by venture capital – the returns earned by early investors in Facebook and Google are well known. However, the countless failed companies where investors lost their capital are less well remembered, so caution is required – most investments will fail.

The earlier the stage you invest at, the greater the likelihood of failure. Seed and start-up financing are, of course, higher risk than growth-stage investments. Investors, therefore, need to carefully select the stage at which they wish to invest in companies, matching this to their risk appetite.

Diversification across different funds, sectors and vintage years is also imperative. Casting your net as wide as possible increases the chance of finding future mega-cap stocks.

Is there a market opportunity?

The big challenge here is, despite pressure from government, whether pension schemes should be investing from a financial perspective. Putting aside the well-known risk and return characteristics, if there's a large flow of assets pushed towards this market, is there the capacity to take this on, or will assets be bid up and returns lowered?

The opacity of the market makes this incredibly hard to answer. And when returns aren't known for over a decade, it could even be impossible. But if there's an increase in capital waiting to be deployed in UK venture and growth companies, this may breed confidence to encourage more companies to start up. Equally, companies from overseas could decide that the UK is a more attractive place to start up or expand, increasing the investment universe. However, the size of uninvested commitments, or 'dry powder', is something to keep an eye on to establish whether large amounts of new money are suddenly being committed to this market.

What positive impact can venture and growth capital have?

Investing in early-stage companies can be seen as investing in the grass roots of the economy, helping start-ups to succeed and grow to become the big companies of the future. It could, therefore, be seen as a way to generate economic growth, job creation and wealth in an economy.

While this is the effect government wishes to have by encouraging increased capital in these spaces, there are additional ways to create a positive impact.

One example could be through targeting particular regions. By far the largest share of UK venture and growth capital investment is made in London. This is, in part, a self-fulfilling prophecy – many of the financers are based in London, causing companies to set up in London to be close to the financers, limiting the investment opportunities across the UK. But there are plenty of investment opportunities outside London, with many regional companies complaining about the challenges of gaining investors' attention. There is, therefore, a chance to create impact by investing in these less appreciated regions, stimulating economic growth. This may help to achieve another key government ambition of Levelling Up, while finding better-priced opportunities with less competition from other investors.

There's also the impact that can be achieved from the types of companies you invest in. For example, investing in companies providing products and services that make a positive impact on society, such as solutions to climate change and biodiversity loss or the increased provision of education services. Venture and growth capital can often be the difference between companies succeeding and failing, so the capital that you provide can have genuine additionality to it, helping these companies to succeed and their important products and services to get to market.

Similarly, favouring companies that are run in particular ways can help to encourage change in the industry. For example, only investing in companies with diverse management and governance bodies, or that have strong environmental, social and governance practices.

The importance of the investment being provided means there are many opportunities to create a positive impact within venture and growth capital markets.

What's the market like?[1]

Another question often raised by investors considering focusing on UK venture and growth capital markets, as opposed to investing globally, is whether the UK market alone is suitable for an investment – is the market large enough, are there enough funds and deals, and is there enough sector diversification to make it an acceptable investment?

When it comes to the sectors represented in the venture capital market, there's a spread across all major industries. However, software companies are typically the largest share by deal value, typically between 20% and 40% of the market, a bias that investors should be aware of before investing.

Over the last 10 years, total investment deal sizes have averaged around £10bn per year, across nearly 3,000 deals. On average, around 70 new funds are launched per year, raising almost £5bn annually. These are averages, with the annual numbers being incredibly varied as the markets quickly move in and out of favour with investors. The numbers suggest that, unless this asset class becomes considerably underinvested, the UK pensions industry could struggle to allocate a meaningful proportion of assets here.

Given the UK is not the only country with a venture capital market, it's important to consider where it would be advantageous to invest overseas. As noted earlier, casting your net as widely as possible is a useful tool for managing risk and maximising your chances of capturing the big success stories. While the government wants to see investments increased in the UK, fiduciary duty may point to considering global opportunities.

So, should you venture into venture capital?

The drivers should always be your aims and requirements. To be able to invest in venture and growth capital, you need a large risk appetite, a long time horizon and the ability to withstand illiquidity.

If you pass those tests, the potential returns on offer are strong, coming with the ability to have a positive impact with your money and drive real-world change. Venture capital also has the ability to diversify a portfolio, offering risk and return drivers typically not seen elsewhere in a portfolio. However, the risk levels and UK market size mean it's unlikely to make up a large share of a portfolio.

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[1] https://pitchbook.com/news/reports/2023-uk-private-capital-breakdown

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