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A Private Equity & Venture Capital industry market snapshot

UNITED KINGDOM

VENTURES BEYOND BREXIT

ENTER >

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INTRODUCTION

Even before the coronavirus pandemic, the UK Venture Capital/ Private Equity sector was facing uncertain times. A combination of Brexit, US-China trade wars and weakening fundamentals weighed heavily on the market and potentially threatened the UK's dominance in the European region. With funds sitting on nearly £1.3tn of assets under management, investments were expected to remain steady. The research for this report was carried out in the summer of 2019, so although it cannot offer any insight into the impact of coronavirus, it does offer a comprehensive overview of the state of the UK markets, including new and emerging trends. Valuations remain high and seem decoupled from soft market fundamentals. Trends emerging from these factors include General Partners' inclination to hold on longer to the top performers, aggressive deleveraging, growth capital garnering significantly higher interest and Limited Partners seeking greater control and say in the strategic direction of funds. It remains to be seen how valuations and the talent pool of investors and investment professionals will be impacted by Britain's unclear EU withdrawal plan and the global pandemic.

This Qodeo report brings unique insights into the background and activities of firms not just in the London hub, but also Cambridge, the north of England, Midlands and Scotland, including Venture Capital, Private Equity, corporate venture arms and Angel groups. Abhishek carried out the research while studying for an MBA at Cambridge Judge Business School.

Abhishek spoke to 100 people from 85 different firms. Interviews took place between July 2019 and August 2019. He made a conscious effort to interview firms from outside the London area to get a picture of the industry in other parts of the UK. Here we share their unique insight into industry trends and their medium - and long-term outlook. The report also provides some general commentary on the investment and entrepreneurial VC & PE community across the UK.

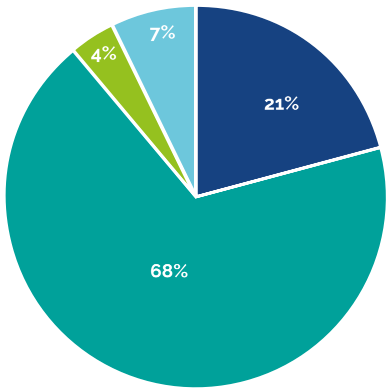
UK tech start-ups beat their half-year record for Venture Capital investment in June 2019, reaching

3.8bn

The previous record in the first half of 2017 was

3.3bn

WHO DID WE SPEAK TO?



Particpating firms by type

- Private Equity firm
- Venture Capital firm
- Corporate venture
- Angel Groups

AGE OF FIRMS

The median age of firms interviewed for this report was 14 years. The table also shows that at least half of the participants follow a 2/20 fee model (ie 2% management fee/20% carried interest). The interviewed firms also expect to deploy nearly £1bn over the next 12-24 months.

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London led the way, attracting investments of

2.5bn

Bristol, Oxford and Cambridge together accounted for

0.4bn

INTERVIEWED PE/ VC FIRM PROFILES

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Metric	Min	Max	Median	Mean	25th Percentile	75th Percentile
Firm Age (Years)	0	31	14	14	5	20
Investment Professionals (Number)	1	100	10	23	6	20
IRR Expectations (%)	17%	40%	29%	29%	25%	31%
Average Investment (M)	0.25	30.0	2.25	4.59	0.76	5.75
Average Stake (%)	10%	60%	25%	25%	15%	25%
Portfolio companies (Number)	0	222	20	46	8	73
Exits till date (Number)	0	165	5	28	0	41
Exits/firm age (Exits per year)	0.0	5.3	0.6	1.5	0.0	2.2
Management Fee (%)	0.0%	2.5%	2.0%	1.8%	1.9%	2.0%
Carry (%)	5%	20%	20%	19%	20%	20%
Average Time to exit (Years)	4	10	5	6	5	7
Follow-on commitment (% of total funds raised)	0%	80%	37%	39%	30%	50%
Deployment- next 12 months (M)	2	480	24	47	7	36
Exits- next 12 months (Number)	0	7	2	2	0	2

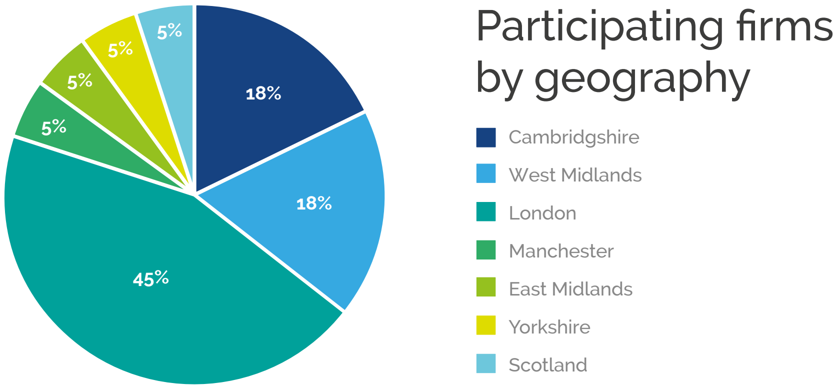
90%

of the firms interviewed were involved in early-stage investments

Firms rely on their network of trusted contacts for deal flow, as well as university incubators and public research bodies

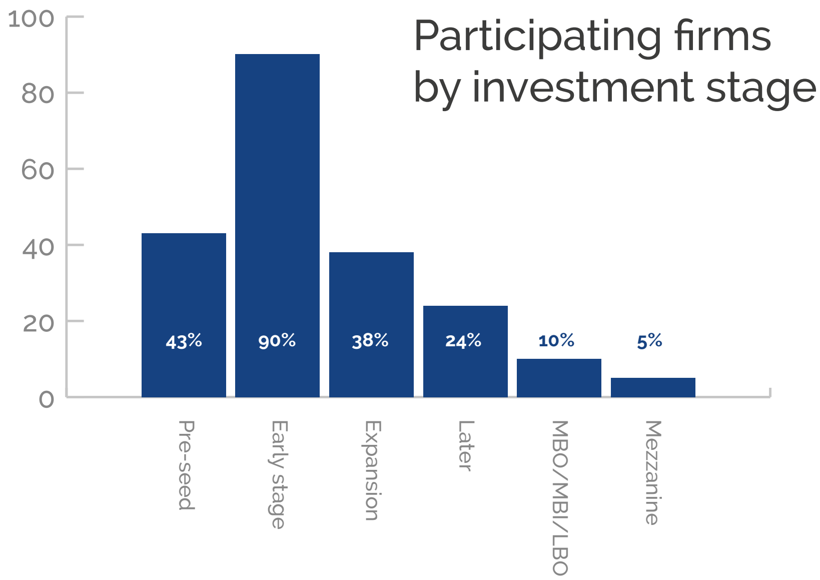
WHERE WERE THE FIRMS LOCATED?

About 45% of the firms interviewed were London-based, with the West and East Midlands and Cambridgeshire making up 41% of the sample.



HOW DO THE FIRMS PREFER TO INVEST?

Most VC firms and angel groups focus on the seed and early (series A, series B) rounds while PE firms focus on the expansion/growth rounds (series B+) and later stage mature companies. These stages are often loosely defined. Sometimes, portfolio companies can fall under multiple stages of development.



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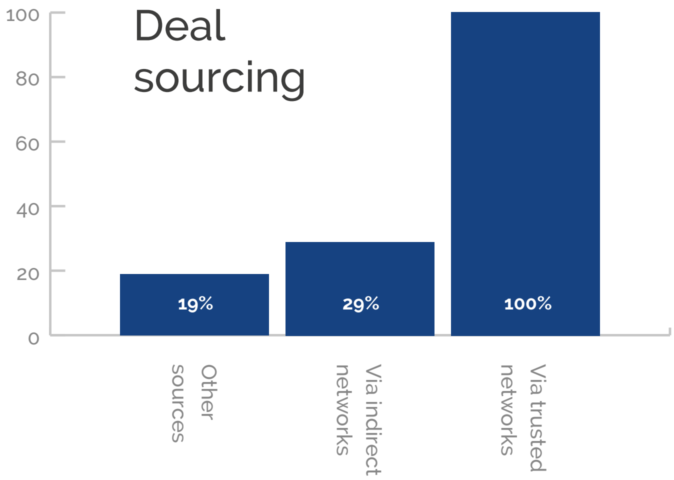
Firms follow the classic

2/20

compensation structure

> The quality of the entrepreneurial team and the size of the potential market were the two most important factors in making investments

HOW DO THE FIRMS CURRENTLY SOURCE DEAL FLOW?



All the firms currently rely on their direct network of contacts for deal flow. About 29% of the investment houses source deals additionally through their indirect network that very often includes entrepreneur contacts and referrals from their portfolio. About 19% of them source deals through other channels like university incubators and public research bodies.

INVESTMENT CRITERIA

The quality of the entrepreneurial team and the size of the potential market were cited by the firms interviewed as the two most important factors when evaluating a potential investment. Each of these factors had a median weightage of 30%. The firms attributed a 20% weighting to the core underlying technology, while the other 20% was shared between metrics like the defensibility of the intellectual property, the financials of the firm, growth or turnaround potential and achievement of specific objectives like Environmental, Social and Governance (ESG) strategies such as combating climate change, portfolio synergies or hurdle rate achievability. 25% of the firms indicated that they don't like unclear thoughts on strategy and growth, while 30% of the firms were deterred by founders with limited experience. Potential for developing repeat exits and coordination between founders were suggested as two key success parameters by 60% of the firms.

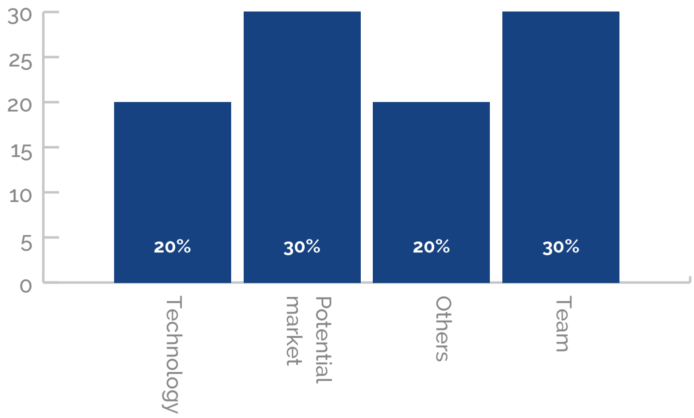
40%

of the firms interviewed avoid competitive bidding

OVER 50%

of the firms perceive an equity gap between late seed and Series A

Key investment decision parameters

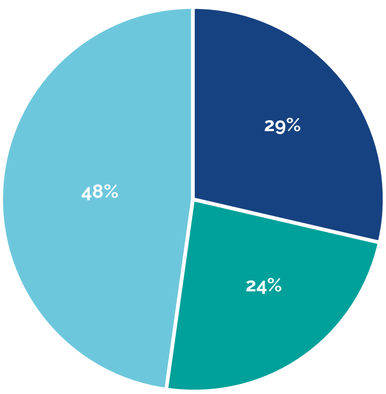


DEAL FLOW LEVELS

Closure rate	Min	Max	Median	Mean	25th Percentile	75th Percentile
Deals evaluated	75	300	150	150	100	150
Closed transactions	1	15	5	4	2	5

Firms closed a median of five deals among 150 evaluated over the previous 12 months. The range was narrow, with firms evaluating between 75 and 300 deals annually. Firms with a larger team evaluated a larger number of deals and made greater number of investments. The investments covered by the study include fresh deals only, not follow-on investments. 40% of the firms indicated an inclination to avoid competitive bidding for deals, as they believed that this reduced their cash-on-cash multiples by nearly 20%.

INVESTMENT ROUND PREFERENCES



Firms by preference to lead rounds

- Prefer to lead
- Prefer not to lead
- Approach deal-by-deal

40%

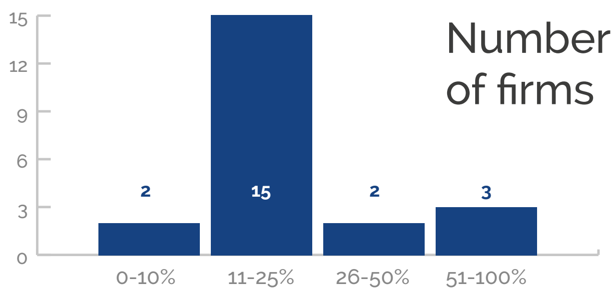
of the firms prefer to lead investment rounds

“

PE firms tend to seek outright ownership, although some will allow founders to keep a small stake

Roughly half the firms had a clear preference whether or not to lead a round, while the other half take a deal-by-deal approach to this decision. Firms varied in their syndication and lead preferences. Angel groups and VC firms generally syndicate because their fund size does not allow for full investment in rounds. By contrast, PE firms generally do not syndicate because they ultimately want to have a full or majority stake in the company. With syndicated deals, 40% of firms indicated that they preferred to lead the round so that they could dictate the terms and have an influence over which other firms joined the round. Firms tend to also be very particular in who they syndicate with because of their past experiences with, and opinion, of other firms.

TARGET EQUITY LEVELS



Firms interviewed by Qodeo varied in the amount of equity they preferred to invest into their portfolio companies. Many firms indicated that they preferred meaningful equity ownership, i.e. equity ownership of at least 10%. Firms generally indicated that they - or their syndicate partners/LPs - wanted meaningful ownership so that they would have influence on the direction of the portfolio company. Most of the firms preferred stake levels of 11%-25%. Over 50% of the firms indicated an equity gap between late seed and the Series A stage.

Despite smaller deal sizes, growth firms and Angel groups have the lowest target equity levels - less than 10%. VC firms generally have target equity levels ranging from 10-25%. PE firms generally seek outright ownership, but sometimes allow founders to keep a small ownership stake of less than 20%.

Several firms with lower target equity levels said that these targets were not set in stone and could vary, depending on a range of factors involved in a deal such as the size of the investment, the company's target sector and the company's valuation. Firms with higher target equity levels (i.e., greater than 50%) placed greater emphasis on achieving those levels. Firms said Healthcare investments generally saw lower stake levels, because of the weak pound and high valuations of American healthcare firms causing higher demand.

80%

of firms interviewed anticipated an increase in average ticket size

"

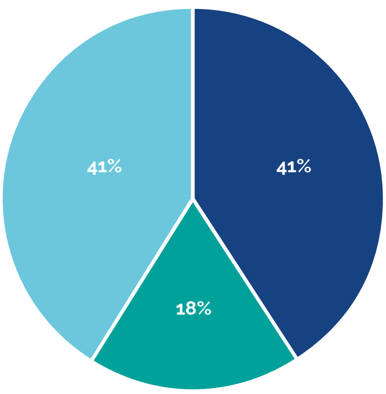
The weak pound and high valuations in American healthcare have resulted in higher valuations and lower stake levels in this sector

PORTFOLIO COMPANY VALUATION

Many firms told us that a company's valuation was also a factor that they considered when making an investment. Price sensitive firms placed significant focus on the potential return on their investment and therefore were cognizant of potential dilution resulting from down rounds if their invested round was overvalued. While pre-emption rights were the most common dilution protection, firms had drag-along and tag-along rights, especially when investing as a consortium. Firms investing in early or seed stage companies considered a company's valuation, but they indicated that this valuation was driven by comparable transactions and the size of the addressable market. 80% of the firms believe that requests for funding at the Series A and growth stages are increasing and hence ticket sizes are on an upward trajectory. Lower valuations and the weak pound have led to better deals in the UK compared with the US, according to 40% of the firms surveyed.

GOVERNANCE

Most firms also expressed an interest in having control or influence over the decisions made by their portfolio companies, specifically through board positions. 100% of firms indicated that they prefer at least a board observer role. 18% of the firms liked to seek both a board and an observer role to mitigate their risk and keep a keen eye on the company's operations. Some firms said they did not seek a board position because they felt it was not worth the amount of work it required. About 60% of the firms wanted at least a board seat. 90% of the firms insisted that board construction and strong investment committee processes were key parameters for smooth successive rounds.



Firms by board preference

- Board only
- Board plus observer only
- Deal-by-deal

60%

of firms wanted at least one board seat on the companies they invested in

90%

viewed board construction and investment committee processes as key parameters for successive rounds

COMPLEX TERMS SHEETS AVOIDED

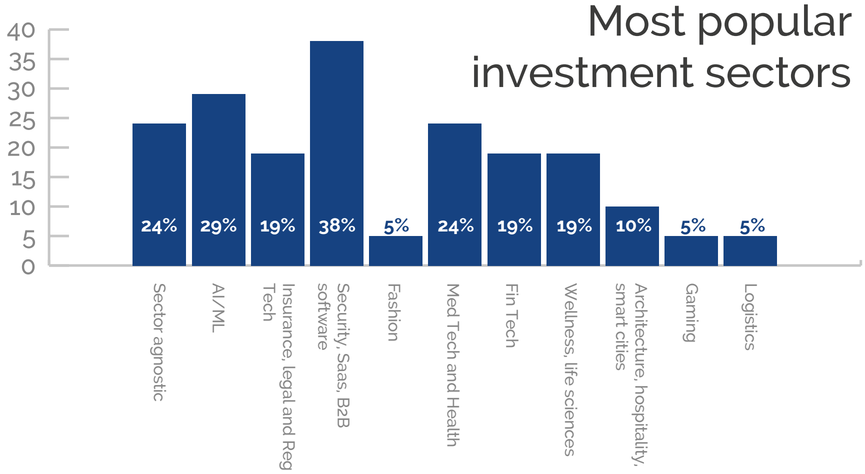
Other deal terms discussed included liquidation preferences, participation, dividends, warrants and anti-dilution. Firms mostly downplayed the importance of these deal terms and said that market terms, such as 1x liquidation preference with no dividends or warrants, are the norm. Firms said that many of these kind of terms tend to overcomplicate deals and can have a negative effect on the relationship with, or motivation of, the company. 35% of the firms suggested an increasing use of Convertible Loans and occasionally Venture Debt.

FRICTION WITH ANGEL GROUPS

75% of the firms indicated that they were willing to write smaller cheques to spot deals early. This, they believed, could lead to friction with Angel investors, who could view this transition as encroachment onto their traditional investment arena. 30% of the firms believe that Venture Capital Trusts and Enterprise Investment Scheme funds don't want to wait and are increasingly moving in earlier, thus increasing the competition for good companies. They also opined that VC ticket sizes will drop and result in increased tension between the Angel and the VC space, which is both an issue for investee companies as well as Angels.

MARKET OVERVIEW

Most popular investment sectors



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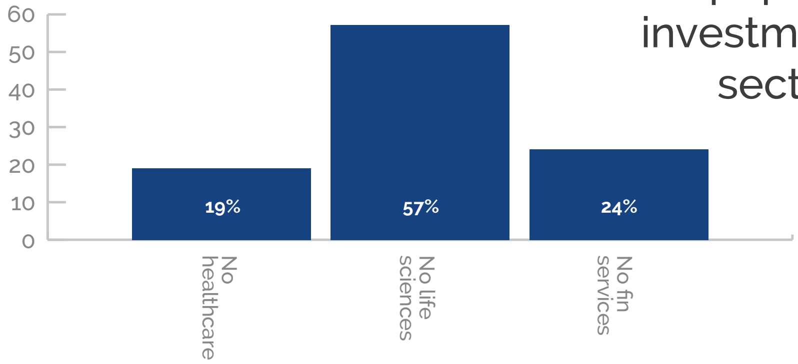
75%

of the firms interviewed indicated a willingness to make smaller investments to catch deals early

"The firms believed VCs have begun to encroach on the Angel investing space

38% of the firms preferred exposure to Security, SaaS or B2B software, while 29% of the firms have some exposure to Artificial Intelligence (AI) or Machine Learning (ML). About 24% of the firms have some investments in Healthcare, while 24% of the firms were sector agnostic. About 19% of the firms preferred exposure to Insurance, Legal or Reg Tech, Fintech and Life Sciences.

Least popular investment sectors

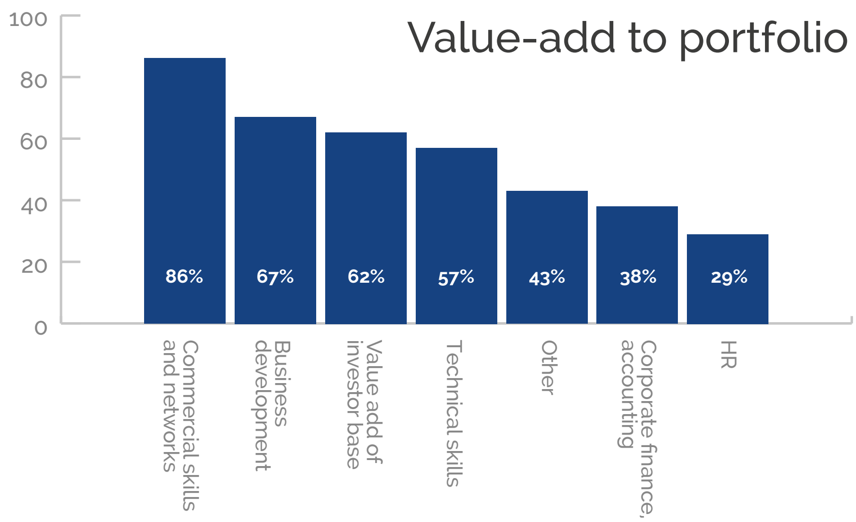


19% of the firms had a clear mandate to avoid Healthcare, while 57% of the firms avoid Life Sciences investments. About 24% of the firms avoid any exposure to Financial Services.

Over 90% of the firms preferred ringfencing investments to exploiting portfolio synergies. These firms also indicated that they did not actively avoid correlation between portfolio companies, but it was, rather, a natural consequence of avoiding investments like the ones they had just made. These firms also indicated that they avoided investing upstream or downstream in the value chain until the investments had matured and the holding period exceeded half the life of the projected exit period.

ADDING VALUE TO INVESTMENTS

Value-add to portfolio



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> Healthcare Tech, Insurance, Reg Tech, AI/ ML and B2B software were the most popular investment sectors

> Life Sciences investments were avoided by most firms

Just under 86% of the firms said they brought commercial skills to their portfolio, while about two-thirds of the firms offered business development assistance to the portfolio. About 62% of the firms believe that the investor base adds both valuation and visibility to the firm, while about 57% of the firms bring technical skills to the portfolio. About 43% of the firms bring portfolio synergies, climate change and ESG support, due diligence and consulting expertise. Only one firm believed that they were a purely financial investor and preferred to take a hands-off approach to investing.

FAILURE RATES, EXITS AND ZOMBIES

Failure rate metrics	Min	Max	Median	Mean	25th Percentile	75th Percentile
Failure Rate	5%	50%	10%	12%	6	15%

For the purpose of this analysis, failure rate is defined as a loss of invested capital, either full or partial. The analysis shows that failure rates of firms ranged between 5% and 50%, with the median failure rate around 10%. The analysis also showed that about a quarter of the investments made by the interviewed firms were "zombies", which while not leading to capital loss, had lingered about in the portfolio for significantly longer than the expected exit deadline. The reasons for the "zombies" included a lack of exit opportunities, inability to scale the business and technological obsolescence, despite possessing an existing customer base.

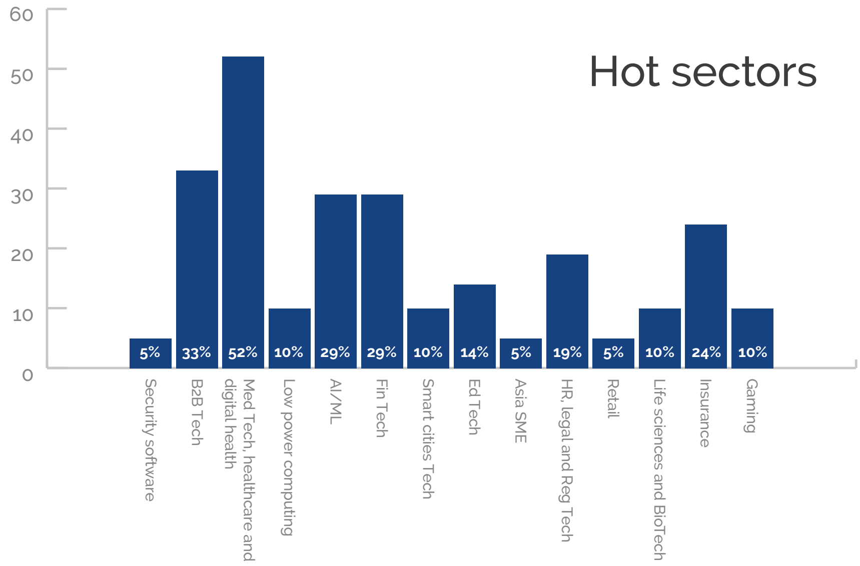
BREXIT DELAYS EXITS

All the firms opined that political and economic uncertainty in the UK had delayed exits. The preferred exit strategy has been an acquisition by competitors. The next best option has been an acquisition by a strategic investor and then a trade sale to a PE investor. The IPO route is the least preferable form of exit. 25% of the firms believe that the future may see reduced management fees but higher hurdle and higher carry, especially as valuations increase and holding periods increase.

"Firms preferred to ringfence investments rather than exploit keiretsu-style synergies across their portfolio"

"Software-as-a-Service (SaaS) and Fintech are extremely popular"

HOT SECTORS - THE FUTURE



Med Tech, Healthcare and Digital Health is the most favoured sector for future investments. Over half the firms have shown a strong inclination to invest in this sector. About 29% of the firms were also keen on investing in Fintech - and a similar percentage saw potential in Artificial Intelligence and Machine Language-powered companies. A quarter of the firms believe that Insurance Tech will be the next big wave, with all of them of the opinion that the sector is primed for disruption. Two interviewed firms dealt largely with companies that looked for cross-border expansion into Asia and Africa. Half of the firms investing in Healthcare indicated that they avoided investing in wearables as the market was very crowded.

A corporate agent told us: "Tech companies find it easier to raise larger ticket sizes. SaaS and Fintech are extremely popular and there is always a focus on the management team. The level of expertise and trust define the entry of funds into new sectors, especially when High Net Worth Investors/family offices are involved. There is an appetite for portfolios, but most investments are individual transactions."

UK FIRMS INTERVIEWED

Birmingham
BGF Birmingham
Midven
NVM Birmingham

Cambridge
Amadeus Capital Partners
Cambridge Innovation Capital
Cambridge Angels

Edinburgh
Archangel Investors

Leicester
Catapult Ventures

London
Pontaq VC
Pembroke VCT
Harmony Capital Investors
Investec

Other VC/PE firm names withheld.

ABOUT QODEOVIEW MARKET SNAPSHOT REPORTS

qodeoview market snapshots are reports written by qodeo-MBA researchers from 30 leading Business School alliance members about key venture/private equity and entrepreneurial trends and markets. These cover EMEA, North America & Asia. Insights gleaned are used by qodeo's investor:entrepreneur matching service and to assist corporate advisors build related pipelines.

Register at www.qodeo.com to receive these as part of our service.

MATCHING INVESTORS WITH ENTREPRENEURS

Qodeo monitors the venture ecosystem, identifies the best opportunities automatically, and brings entrepreneurs, investors and corporate advisors together to make it work. Acting as what one leading VC called **"noise cancellation"** for the global venture community, this is a brand new service for a new generation of entrepreneurs and investors who expect to be able to behave differently, and to do business differently.

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