

Entrepreneurship Debate organised by the Information Technologists' Company

8th October 2008 at K&L Gates

“This House believes there is a shortage of early-stage funding”

Notes of proceedings compiled by John Riley

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Summary

The current global financial crisis and its aftermath is presenting major opportunities for innovation and entrepreneurialism. However, those small to medium nimble and flexible companies best able to take advantage of this emerging new climate are hamstrung by a series of structural gaps and short-comings.

That was a conclusion of an important debate among a broad range of 100 business angels, VCs, financial advisors, consultants and IT entrepreneurs & industry movers organised by the Information Technologists' Company Entrepreneurship Group this month.

There is a major funding gap for those proven successful entrepreneurial organisations seeking £0.5-5m of capital to leverage major growth. That is because Venture Capital has moved up the chain into the Financial Institutions' space to fund larger, less risky enterprises.

Smaller start-up entrepreneurial companies are also finding it harder to get early stage investment with a shrinking pool of "angel" investors, and a lack of effective co-ordination among financiers at this level. Moreover, non asset-backed funding from banks has all but dried up.

It is not just shortage of money that is impacting UK entrepreneurial development, but a continual lowering in recent years of an appetite for risk, a poor infrastructure to accommodate entrepreneurs (for example, among the legal and accounting professions), and a talent gap. There are, for example, only a handful of UK VCs that really understand what they are doing.

The procurement cycle in large business & government needs to change: entrepreneurs typically have to spend two years or more getting decisions from large company prospective purchasers.

This means that most large organisations are missing out on getting in early with new innovative technologies, which could help transform their businesses.

To combat this climate budding entrepreneurs need to adopt a new suite of skills to overcome yet another gap – the entrepreneurship gap. They need to concentrate more on pulling themselves up by their bootstraps ("bootstrapping"); they need to ensure they have people who understand the entrepreneurial process (especially serial entrepreneurs) on their boards; and they need to adopt a global approach from the outset. They also need to raise their sights from selling their companies for the £10m level to sit on a beach for the rest of their lives, to selling, as do many US entrepreneurs, for £100m using that success as a platform to go on to create \$1bn companies.

There is also a gap between industry and the universities. "Education still regards trade and business as dirty. Universities are not interested in turning out entrepreneurs," said one attendee. "The UK education system specialises people earlier than in the US. MIT, for example, is a large industrial conglomerate that happens to have a college attached – therefore there is more breadth and a mindset of connecting to reality."

The motion was put to a vote: 44 voted for the motion; 26 against and 5 abstained. The motion was thus carried.

Charles Hendry MP – Shadow Energy Minister

Giving the Conservative viewpoint, Shadow Energy Minister and former Shadow Business Secretary Charles Hendry called for better procurement processes, getting all the innovation agencies under one roof, and building a culture of entrepreneurship in a culture where we don't allow risk

“We also need to tackle the blame culture – government can take a lead here in promoting an attitude that recognises competition is a part of life, and we need to change our attitude to failure.” Hendry also called for lighter touch regulation which he said is “smothering” entrepreneurs.

In more depth:

- A. There is a funding gap and we need financial structures
- B. There is an entrepreneurial gap and we need (new perception re risk etc.)
- C. There is a leadership gap.

We should do better procurement: there is a role for government getting all the innovation agencies (TSB etc.) under one roof

We need a cultural shift – we can't have a culture of entrepreneurship in a culture where we don't allow risk – e.g. for children

We need to tackle the blame culture – government can take a lead here. We need an attitude that recognises competition is a part of life, e.g. in the school system.

We need to change our attitude to failure. In the US failure is seen as part of experience.

We are smothered with regulations; the way regulations are implemented clamp down on people trying to do business. We need a lighter touch – there's too much crossing 'T's and dotting 'I's (e.g. in Health & Safety).

We're approaching a new era of inventiveness – everything has got to be re-invented because of climate change and carbon reduction culture. Therefore there are tremendous opportunities for people who understand science.

We need to reward people who take risks (our culture is one of rewarding people who have not taken risks – we need to shift the balance)

John Blowers (Founder Pre-Ex), speaking for the motion

There is very much a shortage of early stage funding, especially for technology companies.

Stage A: early stage, back-of-envelope - £200k level – Angels.

Angels are fragmented and disorganised - “you get three or four guys meeting at the golf club looking at a business recommended in a pub”. No angel network has made inroads into making enough money or processing the amount of deals companies deserve.

Stage B: growth stage – they have office, people, sales, need £1m-£5m (traditionally VC)

There is a gap here because Venture Capital has gone up-market and is doing bigger and safer deals. There is a flight to mediocrity and to bigger companies that are safer on due diligence. They are focusing on companies that don't grow so fast and are leaving the (growth stage) companies that can grow fast (risk and return go hand-in-hand).

Stage C: Final stage (exit in sight) – more serious investment institutions and VCs have moved up to this stage leaving hardly anyone funding Stage B growth companies. Banks and non-asset backed debt finance has all but gone

Conclusion:

- VCs are moving to low risk, larger deals and “slam dunk” Management Buy-Outs

- The private equity model is dominating
- Risk avoidance is dominating
- The risk capital equity gap is a large as ever
- There is plenty of money but only for those who don't need it
- We have abandoned entrepreneurs by losing our appetite for risk

David Carratt (Kennet Partners) speaking against the motion

There is an entrepreneur gap.

UK provides over 50% of European VC capital.

European Private Equity (PE) grew because of cheap credit 39% over three years.

European VCs have had loss every year (except 3-year investments which grew only 5%) .

European VCs – is very hard to persuade equity from European VCs – is uphill struggle.

There is no correlation between capital invested and exit value.

Create Value by:

1. Bootstrapping – minimal use of capital to build company initially
2. Building board teams to include entrepreneurial talents, especially from serial entrepreneurs
3. Marketing and sales skills: to sell the business value of the opportunity, not just the commercial value to the customer

Policy response:

- we need to encourage serial entrepreneurship
- need to be tightly engaged.
- need to simplify EIS scheme
- cap on CGT at £2m per exit event
- R&D tax credits to include qualifying sales and marketing
- capital is mobile and will flock to success

Panel Comments and Points from the Floor

It is very difficult for entrepreneurs needing £500k-£1.5m.

AIM did the job – there is a need for an AIM type entity for high risk and maybe suck in Angel equity.

Be very wary of government originated funding – government [should] focus on rewards (e.g. tax related incentives). Government policy can only hurt except for when they make intelligent consistent regulatory base.

With few VCs making money in European there is a terrific market there, big enough to grow companies.

In the UK there is a flow of talent from public listing to private companies because of regulatory compliance. But this is going to private equity rather than to VCs.

US is ahead of the UK in University talent – good movers in UK are universities getting involved in partner nursing (e.g. Imperial College has an Innovator war chest).

Now there is a huge shortage of money until the financial system has sorted itself out.

Getting public sector to support SMEs is very difficult – the US forces SME [to be part of government contracts]

In-Q-Tel – CIA funded a venture firm – its job was to fill the needs of the CIA. It worked for a while.

There is a real gap – there are not 10 people in the UK who actually know how to do VC.

Private Equity investing is simplest – the sandwich in transactions. PE is about buying right and holding on.

VC is not transactional.

The gap is a talent gap – there is just not enough talent. The UK does not have a big infrastructure (e.g. in the US law firms are built around this – in the UK the structure is costly and less useful).

Funding: Silicon Valley Bank funds 50% of VC companies in the US because it has a different business model. Infrastructure (in the UK) is on the way but most of all there is a talent gap.

Small Firms Loan Guarantee – banks put up money and the DTI underwrites – that is a source that has dried up.

if you are trying to build a global partnership (e.g. with oracle or IBM etc.) it can take months. Then you need to prove the proposition. It is a two year cycle to sell to big global companies – but there is no money to fund two-year cycles.

Go direct to the end user and you stand a chance. Don't go through an Oracle or IBM.

It took three years to knock AIG to a decision. We had to do a global [RFB] against Tata and IBM but it was still a huge cycle.

Look at what we're taking to market. The problem is that people are looking for supply push – but want demand pull.

Entrepreneurs identify major market problems – we want entrepreneurs who read the market. “I have always been influenced by Prof Theodore Levett who said: “people don't want a quarter inch drill; they want a quarter inch hole.”

Equity is expensive. Ideas are cheap. It is the execution that is really dear.

An early stage pre-profit company will cost a lot of equity if it is raising money early on: you do have to give up 50% to be a big company

In the UK people sell their companies to sit on the beach; in the US they sell to go on the make \$1bn [i.e. as serial entrepreneurs]

We need more than a local perspective. If you don't think global and articulate that you will have a problem getting funded.

If you fund a company in the UK you are competing with China etc. New [entrepreneurial] talent needs a global point of view

There are no more mid sized VC s – they are either very small or very big. Globalisation exacerbates the problem – it makes money more valuable.

“This is a great time to start a company”. We need to focus on talent.

Everyone is looking for the next e-Bay. There is a lack of understanding of [£3-£5m] opportunities in the SME market that are profitable. No-one wants to talk unless [they can exit] for £20-200m. That makes it hard for service companies.

If you want £3-5m to go to £20m you need a bank

If you want £3-5m to go to £100m – that is interesting for a VC

Education still regards trade and business as dirty. Universities are not interested in turning out entrepreneurs.

The education system here specialises people earlier. In US, for example, the MIT is a large industrial conglomerate that happens to have a college attached – therefore there is more breadth and a mindset of connecting to reality.

We need a process to build relationship between entrepreneurs and VC s before the need for cash.

Global Challenge: is not about funding but about ambition among entrepreneurs. In the US they go for £1bn; in the UK they want £10m so that they can sit on a beach.

“people running private equity funds need tolerance for risk and to understand uncertainty

“ the entrepreneurial community have to argue the need for more entrepreneurial ambition and drive.

More Extensive Notes from the Debate

Charles Hendry MP – Shadow Energy Minister

How can there be a funding gap? City of London is world’s greatest financial centre

How can there be an entrepreneurial gap? Entrepreneurs are admired (Richard Branson; Dragon’s Den etc.)

Problem is lack of leadership and government leadership.

UK is good at innovation but Valley of Death: how to get to stage where innovation makes a difference?

Venture Capitalists want a huge share of equity for little capital

people don’t have business acumen to take innovation to the next stage – that’s where we lose them (e.g. bio-science – bought by Americans)

We should do better procurement: there is a role for government getting all the innovation agencies (TSB etc.) under one roof

We need a cultural shift – we can’t have a culture of entrepreneurship if we don’t allow risk – especially for children

We need to tackle the blame culture – government can take a lead here. We need an attitude that recognises competition is a part of life, e.g. in the school system.

We need to change our attitude. In the US failure is seen as part of experience

We are smothered with regulations; the way regulations are implemented clamp down on people trying to do business. We need a lighter touch – there’s too much crossing “t’s” and dotting “i’s” (e.g. in Health & Safety).

need to move to culture for greater respect for entrepreneurs – this means rewarding people who take risks (our culture is one of rewarding people who have not taken risks – we need to shift the balance)

we’re approaching a new era of inventiveness – everything has got to be re-invented because of climate change and carbon reduction culture. Therefore there are tremendous opportunities for people who understand science.

We’re entering a new phase: starting with the industrial revolution phases have been: resources; then manufacturing; then financing; and now people with inventive solutions.

Singapore is an example of inventive solutions – it has no natural resources. (e.g. it took Roll-Royce 3 days to get go-ahead to build a facility there whereas in UK it would have been years)

We need more paranoia about staying ahead of the game.

(cf: Thomas Friedman: “The World is Flat” - 100,000 science-based graduates in China

Asia is good at science but not necessarily good managerially – (i.e.: this is something you need on top of science to get entrepreneurial)

Yes, there is a funding gap and we need financial structures

Yes, there is an entrepreneurial gap and we need (new perception re risk etc.)

yes, there is a leadership gap above all.

Nick Birtles, Chairman, ITC Entrepreneurial Committee

ITC has 700 members – 20 people on Entrepreneurial Panel looking to help early stage companies make the transition, and promoting knowledge exchange.

ITC is launching a mentoring service to help grow their business and create value.

Stressed importance of the team (Team Awards)

John Blowers (Founder, Pre-Ex)

there is very much a shortage of early stage funding, especially for technology companies.

Funding stages in the UK are:

Stage A: early stage, back-of-envelope - £200k level – Angels

Stage B: growth stage – they have office, people, sales, need £1-5m (traditionally VC)

Stage C: Final stage (exit in sight) – more serious investment (institutions)

Angels: are fragmented and disorganised - “you get three or four guys meeting at the golf club looking at a business recommended in a pub”. No angel network has made inroads into making enough money or processing the amount of deals companies deserve

Venture Capital: that has gone up-market and is doing bigger and safer deals.

Banks now won't lend to companies without assets. Technology companies are service industry but asset poor.

There is a flight to mediocrity and to bigger companies that are safer on due diligence. They are focusing on companies that don't grow so fast and are leaving the (growth stage) companies that can grow fast (risk and return go hand-in-hand)

[message, therefore, is that there is a gap between Stage A and Stage C – hardly anyone is funding Stage B]

with government focus on small companies we get large companies re-inventing themselves to look like small companies

Banks and non-asset backed debt finance has all but gone

[e.g.: CTV has loads of orders but cannot fulfil order books because of lack of capital]

EIS does what it says on the tin – takes risks

Conclusion:

VC s are moving to low risk, larger deals and “slam dunk” Management Buy-Outs

the private equity model is dominating

risk avoidance is dominating

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there is plenty of money but only for those who don't need it

we have abandoned entrepreneurs by losing our appetite for risk

David Carratt (Kennet Partners)

There is an entrepreneur gap.

UK provides over 50% of European VC capital

European Private Equity (PE) grew because of cheap credit 39% over three years

European VC s have had loss every year (except 3-year investments which grew only 5%)

European VC's – is very hard to persuade equity from European VCs – is uphill struggle.
Since 2005 there have been 82 European VC exits greater than £45m.

There is no correlation between capital invested and exit value – therefore you don't make more money putting more money into backing winners, therefore introducing additional capital is unlikely to create more value.

Europe has 20% of capital investment of the US. Therefore 80% less capital is producing 25% of exits over \$50m (for US and Europe totalled)

How to create Value:

1. Bootstrapping – minimal use of capital to build company initially
2. building board teams to include: entrepreneurs; management; serial entrepreneurs; investors – boards are adversarial and don't release entrepreneurial talents – there are less serial entrepreneurs
3. Marketing and sales skills: they especially need skills about selling the value of the business . They are good at selling products but not at selling the business value of the opportunity – they just talk about the commercial value to the customer

Bootstrap: most of the successful IT companies (Siebol, Cisco, Microsoft etc. etc.). The Stage A-C model is broken. I build personal relationships with entrepreneurs and deal direct – not multi stage financing

Board Teams: Analogy of mountaineering. There are a lot of guides at the bottom of the mountains and a lot of mountaineers not at the top. The entrepreneur wants rational, objective experience about the mountains. Fewer than 200 VC and entrepreneurs have been on the board of a European company therefore not much experience.

A lot of boards discuss corporate governance and not about entrepreneur reporting on progress made

Policy response:

- we need to encourage serial entrepreneurship
- need to be tightly engaged.
- need to simplify EIS scheme
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Comments from Panel

Simon Reeve:

From the perspective of entrepreneurs needing £500k-£1.5m, it is very difficult to do today what we could do before.

There are structural constraints in what people can invest in. If I propose something to an institution I can't tick boxes – don't get in front of investment committee (unlike 10 years ago)

There is a serious gap – I'm in the middle of it. SMP has 100 customers and can't get funding

John O'Connell:

AIM did the job – there is a need for an AIM type entity for high risk and maybe suck in Angel equity

Government: am very wary of government originated funding – government [should] focus on rewards (e.g. tax related incentives)

Felda Hardyman:

None of this is about risk.

Inventors avoid risk – it is about balancing reward with risk.

On the European VC chart: Felda's view is that no-one made money there (although Kennet do understand it and made money) therefore there is a terrific market there.

The EU is a good market – it is a big enough market to grow big companies

The EU is working to allow companies to scale to world size

Public markets are everywhere – when IPO markets open up you can take a company public anywhere – and it becomes easy.

Skills are increasing because of role models (e.g. Skype, Cambridge S... Radio)

I believe there is a funding gap and a tremendous opportunity

Government has absolutely nothing to do with this. Government policy can only hurt except for when they make intelligent regulation. Government sponsored capital? - it works in Israel and some places but we're far beyond that here.

We need a consistent regulatory base – as long as it is consistent we can work around it.

Howard Flight:

EIS is a trade body for lawyers and accountants working in the VC area - it lobbies the Treasury.

Both speakers are correct. EIS [members?] raised £12bn.

- disappointing VC returns are correct – EIS funds for early stage people – there are a lot of early stage people – screwed because they have no say

EIS funds need to be simplified because of the tax paperwork etc.

In the UK there is a flow of talent from public listing to private companies because of regulatory compliance. But this is going to private equity rather than to VCs.

Banks are in a position to say to private equity people look at the VC force

US is ahead of the UK in University talent – good movers in UK are universities getting involved in partner nursing (e.g. Imperial College has an Innovator war chest).

Now there is a huge shortage of money until the financial system has sorted itself out.

The Debate

Nic Birtles: getting public sector to support SMEs is very difficult – the US forces SME [to be part of government contracts]

Felda Hardymon: Getting the government in is bad. It is difficult for US companies to sell to the US government – it just means more fuffle to go through. In-Q-Tel – CIA funded a venture firm – it’s job was to fill the needs of the CIA. It worked for a while.

There is a real gap – there are not 10 people in the UK who actually know how to do VC. Private Equity investing is simplest – the sandwich in transactions. PE is buying right and holding on. VC is not transactional.

The gap is a talent gap – there is just not enough talent. The UK does not have a big infrastructure (e.g. in the US law firms are built around this – in the UK the structure is costly and less useful).

Funding: Silicon Valley Bank funds 50% of VC companies in the US because it has a different business model. Infrastructure (in the UK) is on the way but most of all there is a talent gap.

Nic Birtles: One scheme - Small Firms Loan Guarantee – banks put up money and the DTI underwrites – that is a source that has dried up.

Howard Flight: That worked well initially. The money was small, therefore was early stage. The problem with public contracts is that the rules are biased against small business.

Felda:

[UDI?] got £1m of software from the NHS – government buys lots of stuff. False sirens. All companies need a [strategy for dealing with government]: allow 3-4 years – you won’t move the needle – need people.

John O’Connell: We got US government contracts. Worked through private contractors. Small loans guarantee: why should people avoid mortgaging their house: “I couldn’t articulate the investment proposition” - therefore the mortgage is everything. Entrepreneurs are unbalanced people.

Simon Reeve: If you are trying to build a global partnership (e.g. with oracle or IBM etc.) it can take months. Then you need to prove the proposition. It is a two year cycle to sell to big global companies – but there is no money to fund two-year cycles.

Q: We are a small spin off from Reuters. Go direct to the end user and you stand a chance. Don’t go through Oracle or IBM.

Simon Reeve: We needed distributors. It took three years to knock AIG to a decision. We had to do a global [RFB] against Tata and IBM but it was still a huge cycle.

Simon Orme: Dimension: look at what we’re taking to market. The problem is that people are looking for supply push – but want demand pull.

Entrepreneurs identify major market problems – we want entrepreneurs who read the market. “I have always been influenced by Prof Theodore Levett who said: “people don’t want a quarter inch drill; they want a quarter inch hole.”

Richard Knox-Johnston: set up: www.iwantoneofthose.com in 1999. Started with 15k and a computer and sold a Mig25. To expand we needed a £3m injection. But the banks would only give £750,000. The VCs were poor – they sold for £10.5m – that was a shame because the company that bought us just wanted our expertise.

Felda Hardymon: With £3m would you have made £20m? But with 50% of the company? Equity is expensive. Ideas are cheap. It is the execution that is really dear. An early stage pre-profit company will cost a lot of equity if it is raising money early on: you do have to give up 50% to be a big company.

Nic Birtles: In the UK people sell their companies to sit on the beach; in the US they sell to go on the make \$1bn [i.e. as serial entrepreneurs]

John Yeomans: US always had ability to scale quickly. Question is in a more global market whether the supply side of finance [?will help raise] sales across Europe – vis a vis the Far East.

Simon Reeve: We need more than a local perspective. If you don't think global and articulate that you will have a problem getting funded.

Felda Hardymon: If you fund a company in the UK you are competing with China etc. New [entrepreneurial] talent needs a global point of view. There are no more mid sized VC s – they are either very small or very big. Globalisation exacerbates the problem – it makes money more valuable.

“This is a great time to start a company”. We need to focus on talent.

Ben Rapp (Chair, Intellect's SME Group): Everyone is looking for the next e-Bay. There is a lack of understanding of [£3-£5m] opportunities in the SME market that are profitable. No-one wants to talk unless [they can exit] for £20-200m. That makes it hard for service companies. I'm not talking about a 10x exit, but about something that has value now.

Felda Hardymon: Services businesses should not raise equity capital – it doesn't make sense. If you want £3-5m to go to £20m you need a bank If you want £3-5m to go to £100m – that is interesting for a VC.

Q: In the UK the Silicon Bank is for debt handling and that is building fast.

Howard Flight: Immigrants from India are good entrepreneurs. Education still regards trade and business as dirty. Universities are not interested in turning out entrepreneurs.

Felda: Gene pool: there is a lot of talent in the UK but it is a virtuous circle and is not warmed up yet. In the US you find 5 VCs who are able to talk on any topic.

The education system here specialises people earlier. MIT is a large industrial conglomerate that happens to have a college attached – therefore there is more breadth and a mindset of connecting to reality.

Steven Cassell: Anglo Saxon founded companies. Founded OTC market 30 years ago. - securitisation – massive fall out – debate on new ideas for structuring to get money for start-ups. We need a discussion about the money market.

Q: We need a process to build relationship between entrepreneurs and VC s before the need for cash.

Neil Gandhi: Global Challenge: is not about funding but about ambition among entrepreneurs. In the US they go for £1bn; in the UK they want £10m so that they can sit on a beach.

Other:

“People running private equity funds need tolerance for risk and to understand uncertainty.”

“The entrepreneurial community have to argue the need for more entrepreneurial ambition and drive.”