



House of Commons
Committee of Public Accounts

**Department for
Business, Innovation
and Skills: Venture
capital support to small
businesses**

**Seventeenth Report of Session
2009–10**

*Report, together with formal minutes, oral and
written evidence*

*Ordered by the House of Commons
to be printed 1 March 2010*

HC 271
Published on 9 March 2010
by authority of the House of Commons
London: The Stationery Office Limited
£0.00

The Committee of Public Accounts

The Committee of Public Accounts is appointed by the House of Commons to examine “the accounts showing the appropriation of the sums granted by Parliament to meet the public expenditure, and of such other accounts laid before Parliament as the committee may think fit” (Standing Order No 148).

Current membership

Mr Edward Leigh MP (*Conservative, Gainsborough*) (Chairman)
Mr Richard Bacon MP (*Conservative, South Norfolk*)
Angela Browning MP (*Conservative, Tiverton and Honiton*)
Mr Paul Burstow MP (*Liberal Democrat, Sutton and Cheam*)
Mr Douglas Carswell (*Conservative, Harwich*)
Rt Hon David Curry MP (*Conservative, Skipton and Ripon*)
Mr Ian Davidson MP (*Labour, Glasgow South West*)
Nigel Griffiths MP (*Labour, Edinburgh South*)
Rt Hon Keith Hill MP (*Labour, Streatham*)
Sarah McCarthy-Fry MP (*Labour, Portsmouth North*)
Mr Austin Mitchell MP (*Labour, Great Grimsby*)
Dr John Pugh MP (*Liberal Democrat, Southport*)
Geraldine Smith MP (*Labour, Morecombe and Lunesdale*)
Rt Hon Don Touhig MP (*Labour, Islwyn*)
Rt Hon Alan Williams MP (*Labour, Swansea West*)
Phil Wilson MP (*Labour, Sedgefield*)

The following members were also members of the committee during the parliament:

Angela Eagle MP (*Labour, Wallasey*)
Mr Philip Dunne MP (*Conservative, Ludlow*)

Powers

Powers of the Committee of Public Accounts are set out in House of Commons Standing Orders, principally in SO No 148. These are available on the Internet via www.parliament.uk.

Publication

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at <http://www.parliament.uk/pac>. A list of Reports of the Committee in the present Session is at the back of this volume.

Committee staff

The current staff of the Committee is Sian Woodward (Clerk), Lori Verwaerde (Senior Committee Assistant), Pam Morris and Jane Lauder (Committee Assistants) and Alex Paterson (Media Officer).

Contacts

All correspondence should be addressed to the Clerk, Committee of Public Accounts, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5708; the Committee’s email address is pubaccom@parliament.uk.

Contents

Report	<i>Page</i>
Summary	3
Conclusions and recommendations	5
1 Performance management	7
2 Improving programme and fund design	11
Formal Minutes	13
Witnesses	14
List of written evidence	14
List of Reports from the Committee of Public Accounts 2009–10	15

Summary

Since 2000 the Department for Business, Innovation and Skills (the Department) and its predecessors have invested public money, alongside private investors, in a series of funds managed by private sector fund managers. The funds provide support to small businesses unlikely to receive support from other sources. The programme currently comprises 28 funds. By December 2009 taxpayers had contributed £338 million, alongside £438 million from private investors.

Businesses receiving support say it has enabled them to get started more quickly and attract funding alongside other investors. But the distribution of funding from national funds has been concentrated in London and the South East, reflecting the location of many fund managers.

The Department's intervention in the venture capital market was experimental and risky, yet it did not set clear, prioritised objectives for the funds, including the expected economic benefits, and did not set targets at the outset for expected rates of return. There is evidence that the Department has learned some lessons over time but it did not begin to properly evaluate the progress of its early funds until late 2008 and did not publish a report until December 2009.

The Committee was surprised and concerned that, until December 2009, the Department had published no information on the performance of these funds. While recognising that many individual investments would fail, the Department expected that any losses would be outweighed by the gains made on successful investments. The evidence so far suggests that the funds supported by the Department are underperforming. As at December 2008 the Regional Venture Capital Funds, the largest category of early funds, showed negative returns and the average rate of return was minus 15.7%. In comparison, private European venture capital funds of a similar size but with fewer investment restrictions had an average rate of return of minus 0.4%.

We are also concerned that the Department has not done enough to curtail the high costs of managing the funds. Fees for the Regional Venture Capital Funds, for example have totalled £46 million compared to the £130 million invested, and substantial fees have been paid to fund managers even though the performance of the funds has been poor.

On the basis of a Report by the Comptroller and Auditor General,¹ we took evidence from the Department for Business, Innovation and Skills and Capital for Enterprise Limited on how the funds established since 2000 had been managed and what actions had been taken to improve the programme and design of funds.

1 C&AG's Report, *The Department for Business, Innovation and Skills: Venture capital support to small businesses*, HC (2009–10) 23

Conclusions and recommendations

- 1. Despite investing taxpayers' money in venture capital funds for almost ten years, the Department failed to establish a basic set of economic and financial objectives vital for setting clear direction for this set of funds.** As a priority the Department should set clear, prioritised objectives for the programme as a whole and the individual funds including, in particular, the intended economic benefits for businesses. It should then set targets for measuring their success.
- 2. This was a new and risky programme but it was eight years before the Department even began to evaluate the impact of these funds.** The Department should, within the next two years, be in a position to demonstrate whether value for money is being achieved. In doing so, it should assess both the past and likely future financial performance of the funds and the economic impact secured. It should also evaluate the impact of the investment on individual businesses, including whether limits on the amounts that can be invested have reduced the likelihood of significant successes.
- 3. The early funds were structured in a way that meant the taxpayer bore a disproportionate share of the risk compared to private sector investors, and hence greater losses.** When developing new funds the Department, building on the improvements made to the design of more recent funds, should avoid structures which give preference to the interests of private investors and leave the taxpayer with substantial risks.
- 4. We are concerned that the Department and Capital for Enterprise Limited do not have a grip on the cumulative fund management fees incurred by these funds, and by paying fees regardless of performance, have been prepared to reward failure.** The large number of funds plus the small size of individual investments are likely to have increased the costs. For the future, the Department should reduce the number of funds to focus its investments on those areas most likely to yield benefits to the taxpayer. Where there is evidence of poor performance by fund managers, Capital for Enterprise Limited should take prompt action to reduce fees.
- 5. Despite investing taxpayers' money in funds, the Department has accepted restrictive confidentiality clauses and until late 2009, there was scant information in the public domain about the performance of the funds.** Capital for Enterprise Limited has recently published some aggregated data about the funds. It needs to build on this by providing a clear up-to-date picture of where investments have been made and of how the funds have performed, including the extent of any successes and write-offs. For future funds, the Department should avoid entering into confidentiality agreements which restrict its ability to be transparent about fund performance.
- 6. There is a risk that the current pattern of investment, concentrated in London and the South East, reinforces inequalities between regional economies.** The geographical distribution of investment activity for the national funds tends to coincide with where fund managers are located. Capital for Enterprise Limited

should make fund managers aware of the Department's remit to reduce inequalities between regional economies to avoid the risk that promising businesses in the regions are overlooked. Capital for Enterprises Limited should also publish data on the regional distribution of funds and fund managers.

7. **The Department lacks a clear picture of how its national programme of venture capital funds fits alongside other venture capital funds established and managed by Regional Development Agencies.** The Department and Regional Development Agencies should collate information on the aims, objectives, and amounts invested in the various publicly-supported venture capital funds. The Department should use this information, working with other relevant public bodies, to ensure that funds complement each other, that any potential duplication of effort is avoided, and that common objectives are pursued efficiently.

1 Performance management

1. Since 2000 the Department for Business, Innovation and Skills (the Department) and its predecessors have invested £338 million in a series of 28 venture capital funds, which have provided finance to over 800 businesses (**Figure 1**). The aim of the funds is to address a gap in the market, known as the equity gap, whereby small, new businesses with strong growth prospects find it difficult to obtain equity finance from private investors, particularly between £250,000 and £2 million. Investors perceive these investments to be risky relative to larger, later-stage investments and costly to manage.²

Figure 1: The Department's venture capital funds

Scheme name	Year commenced	Fund sizes (note 1)	Maximum investment
UK High Technology Fund	2000—one fund investing in nine underlying funds	£126.1 m	No limit
Regional Venture Capital Funds	2002—seven funds 2003—two funds	Individual funds range from £12m–£46m Total raised £226.5m	£500,000
Community Development Venture (Bridges) Funds	2002—two funds, A and B	A) £28m B) £12m	A) £500,000 B) No limit
Early Growth Funds	2002—one fund 2003—two funds 2004—three funds	Individual funds range from £3m–£5m Total raised £91m	£100,000
Enterprise Capital Funds	2006—five funds 2007—one fund 2008—two funds	Individual funds range from £10m–£30m Total raised £205m	£2m
The Aspire Fund	2008—one fund	£12.5m May raise up to £25m in co-investment	£1m
Capital For Enterprise Fund	2009—one fund investing in two underlying funds	Individual funds £30m plus a co-investment provision of £15m Total raised £75m	£2m

Note 1: Fund size relates to amounts committed by the Department and other investors or raised through co-investment; and not to current valuation. Co-investment is explained in C&AG's Report, para 1.10

Source: C&AG's Report, Figure 1

2. The Department did not set clear, prioritised objectives for the programme and funds, and with the exception of one fund, did not state an economic objective, for example in terms of the intended benefits to businesses. No clear targets were set, with no explicit rate of return being defined at the outset, although Capital for Enterprise Limited argued that a target return was implicit in the incentive structure put in place for fund managers. The Department acknowledged that there had been weaknesses with setting objectives and establishing a clear means of evaluating performance. The Department had made some improvements to the more recent funds, for example including a financial objective for the Enterprise Capital Funds but it had failed to define key terms such as which costs were to be included in assessing whether the funds were cost-neutral.³

² Qq 49 and 108; C&AG's Report, paras 1.4, 2.7 and 2.17, Figure 1

³ Qq 3, 10 and 97; C&AG's Report, para 2.3

3. The Department accepted the Comptroller and Auditor General's conclusion that in the absence of a robust measurement framework it could not demonstrate whether the programme represented value for money. The Department committed itself to demonstrating within the next two years whether it is achieving value for money, bearing in mind that it would be some years before the final financial performance of these funds is known.⁴

4. Despite the inherent riskiness of this programme, the Department did not begin an interim evaluation of the Regional Venture Capital Funds and the Early Growth Funds until late 2008, eight years after the first fund was launched. The results of this interim evaluation were not published until the Comptroller and Auditor General published his own report in December 2009. The Department argued that it was not possible to evaluate the returns from these schemes until after about eight years of operation, bearing in mind that they may not reach maturity for 10 to 12 years. While it can take some years for financial performance to become clear, other aspects would have benefited from evaluation, for example, the impact of the funds on closing the equity gap, their success in attracting a flow of good quality business ideas, and whether the fund design was working as intended.⁵

5. Businesses in receipt of support have reported benefits, in particular enabling them to press ahead quickly with their plans and making it easier for them to attract investment from other investors. The Department reported, for example that an average of seven new jobs per company were created through finance from these funds, 42% of companies reported they had started or increased exports, and 70% of all companies receiving investment were surviving.⁶

6. The taxpayers' contribution to these funds is intended to be an investment, thereby offering the prospect of a return, but the performance of the early investments to date has been poor. The Regional Venture Capital Funds collectively show an interim rate of return at December 2008 of minus 15.7%. This is below the performance of similarly sized private European funds established at the same time of minus 0.4%. Current valuations of the Regional Venture Capital Funds, as set out in the Department's Accounts for 2008–09, show that the original Government investment of £74 million has fallen to just £5 million, suggesting that a large proportion of the taxpayers' investment is at risk. In part, this valuation reflects the fact that the taxpayer is bearing a much larger share of the risk on these early funds, compared to the private sector investors in these funds who currently expect a return of between two and 10%. Capital for Enterprise Limited considered that some good quality investments remained in these funds, although the recession was affecting the commercial prospects of some in the immediate term.⁷

7. Even though investment took place at a time when the economy was booming, some funds struggled to invest as much as initially envisaged (**Figure 2**). Capital for Enterprise Limited argued that because of the experimental and innovative nature of the funds, there

4 Qq 1, 113 and 119; C&AG's Report, paras 16 and 2.14

5 Qq 1, 54, 55 and 103; C&AG's Report, paras 2.19 and 3.15–3.17

6 Q 22; C&AG's Report, paras 2.4–2.6

7 Qq 4–9, 34–35, 53–54, 62, 65–66 and 100; C&AG's Report, paras 2.16 and 2.17

could be no certainty about how much they could invest, and fund size at the outset was largely based on estimates of how much the fund managers could persuade the private investors to invest. This under-investment is, however, all the more surprising given that the taxpayers' interest in these early funds was subordinated to that of the private investors, thereby leaving substantial risks with the taxpayer.⁸

Figure 2: The amount of un-invested funds where investment periods are closed

Fund	Total raised from the Department (£m)	Total raised from other investors (£m)	Total fund size (£m)	Invested businesses	Gross cost of investment (£m)	Fund management costs (£m)	Total un-invested funds (£m) Note 1
UK High Technology Fund	20.0	106.1	126.1	245	112.0	19.5	0
Regional Venture Capital Funds	74.4	152.1	226.5	356	132.8	46.1	47.7
Community Development Venture (Bridges) Funds	20.0	20.0	40.0	28	26.5	7.7	5.8
Total	114.4	278.2	392.6	629	271.3	73.3	53.5

Note 1: For the UK High Technology Fund the un-invested total does not directly reconcile to the difference between the total fund size and the gross cost of investment and fund management costs owing to exchange rate differences and because management fees can be paid out of income and capital proceeds.

Source: Qq 41–47; C&AG's Report, Figures 1 and 11

8. Some of the funds have proved expensive to manage. The fund management costs of the Regional Venture Capital Funds to December 2008, for example, were particularly high totalling £46.1 million or 36 % of the £132.8 million invested. Around 30% of the total fund management costs will be met by the taxpayer, in line with its contribution to the total size of the fund, provided the funds realise a sufficient return to pay off other investors' capital plus a 10% return, otherwise the taxpayer will bear a bigger share. The total final cumulative cost of fees paid will not be known until the funds are wound up.⁹

9. Fund Managers are paid an annual fee and can earn a share of the final proceeds provided the fund is profitable when it is wound up. The fees are intended to cover the costs of managing the portfolios, including providing advice and other support to invested businesses. Capital for Enterprise Limited has procedures in place for monitoring the performance of fund managers and in two instances had used its influence to reduce fees to fund managers by £0.7 million where they had made lower investments than initially expected. But it did not set out in agreements with fund managers what constitutes underperformance and therefore any reduction is a matter for agreement with the fund manager.¹⁰

10. Until late 2009 the Department had published no information on the performance of the venture capital funds. The Department accepted the need for greater transparency and

8 Qq 41–47; C&AG's Report, para 2.16, Figures 1 and 11

9 Qq 14–16, 21, 30–32 and 37–40; C&AG's Report, paras 2.16 and 3.14

10 Qq 47,53–54, 69–81 and 112; C&AG's Report, paras 3.11–3.13

Capital for Enterprise Limited had published on its website aggregate information in December 2009 about the funds, including the amounts invested and where investments had been made. No information had been published however on the performance of the individual funds. Capital for Enterprise Limited argued that legal agreements governing the operation of the funds, in line with practices adopted in the venture capital industry, restricted publication of certain information on commercial confidentiality grounds.¹¹

11 Qq 24–30, 33, 36, 64 and 104–105; C&AG’s Report, p 10, recommendation 17e and para 3.19

2 Improving programme and fund design

11. The Department has made various estimates of the size of the equity gap. In 1999 the Department considered the equity gap affected investment up to £500,000. A further assessment in 2003 based on wider research indicated a gap between £500,000 and £2 million. Businesses and other stakeholders consulted by the National Audit Office estimated the gap to be at least as much, and potentially up to £5 million. Capital for Enterprise Limited quoted recent research by an American academic who concluded that without government intervention funding for businesses would not be available. Capital for Enterprise Limited noted that venture capital investment in the UK is significantly less than in the United States where government had been involved in this area since 1958 and where support as a percentage of gross domestic product was 2.5 times the UK level.¹²

12. Limits on the level of taxpayer investment in individual businesses may have constrained the ability of the funds to adequately invest in success. Investments from Regional Venture Capital Funds, for example, were originally limited to £500,000, to comply with European Union rules governing the provision of state aid to businesses. Capital for Enterprise Limited believed that it had to pitch its funds to cover the range of the equity gap where private investors would not normally invest, while avoiding displacement of other investment at the point where private investors are prepared to commit larger sums of equity. The Department had recently reached agreement with the European Commission that the investment limit for the Enterprise Capital Funds could be raised to £2 million, provided private investors in the fund were not treated preferentially. The Department is also establishing an Innovation and Investment Fund with the aim of investing larger amounts in high technology businesses in a way that does not raise state aid issues.¹³

13. The creation of a large number of individual funds each making a large number of small investments has not proved to be an optimal structure for the Department's programme. The Department has launched 28 venture capital funds since 2000 and individual investments have generally been small scale. The average investment to date, for example, from the Regional Venture Capital Funds was just £373,000, lying towards lower end of the equity gap. The Department accepted that, in hindsight, it had launched too many funds making them difficult and costly to manage. It intended to streamline and rationalise the funds into a more coherent programme. This process would take time as the legacy funds would continue to manage their residual investments.¹⁴

14. The pattern of investment on the national funds risks reinforcing existing regional economic inequalities. The distribution of investments from the Department's funds tends to reflect the location of fund managers, half of whom are in London and the South East compared to 43% of their investments (**Figure 3**).¹⁵ Capital for Enterprise Limited noted that investment across all the funds was in line with the balance of regional economies so

12 Qq 49, 96–97, 99 and 108; C&AG's Report, para 2.7

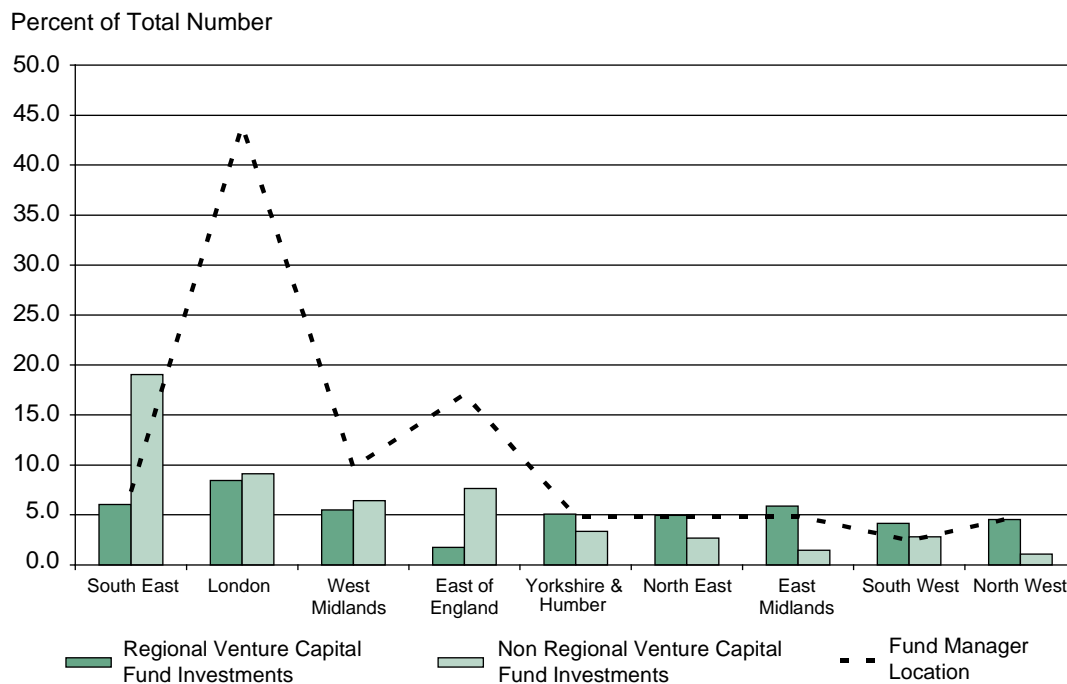
13 Qq 50, 67–68, 90–94 and 98; C&AG's Report, para 2.8

14 Qq 11, 48–49, 68 and 103; C&AG's Report, Figures 1 and 11

15 Qq 17–20, 56–61 and 100; C&AG's Report, paras 2.9 and 2.10, Figure 6

that all areas received a proportionate share. This does not necessarily fit alongside the Department's Public Service Agreement target to improve the economic performance of all English regions and reduce the gap in economic growth rates between regions.¹⁶ The Department acknowledged that there was a risk of concentration in the South East.¹⁷

Figure 3: Distribution of investments by the Department's funds across the English regions



Source: C&AG's Report, Figure 6

15. The Department's programme of investment sits alongside a series of venture capital funds established independently at regional level by the Regional Development Agencies. All the Regional Development Agencies have such funds. The Department reported that the three regions in the North West, North East, and Yorkshire and Humberside have particularly large funds which are matched by loans from the European Investment Bank. The establishment of the funds had reflected the way in which money had been made available from the European Union. The Department reported that it had agreed a national framework in 2009 to improve the sharing of information and coordination between national and regional funds. There remains a risk, however, that taken together, the funds do not represent a coherent programme of support. The Government had recently commissioned a review looking at whether there was an effective national programme, including an effective pipeline of regional investment.¹⁸

16 The Department for Business, Innovation and Skills, *Autumn Performance Report 2009*, page 8

17 Q 61

18 Qq 61, 110-111 and 114

Formal Minutes

Monday 1 March 2010

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon

Mr Douglas Carswell

Rt Hon David Curry

Nigel Griffiths

Mr Austin Mitchell

Geraldine Smith

Draft Report (*Department for Business, Innovation and Skills: Venture capital support to small businesses*), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 15 read and agreed to.

Conclusions and recommendations 1 to 7 read and agreed to.

Summary read and agreed to.

Resolved, That the Report be the Seventeenth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Wednesday 3 March at 3.30 pm]

Witnesses

Wednesday 13 January 2010

Page

Mr Simon Fraser, Permanent Secretary and **Ms Emma Squire**, Deputy Director SME Finance Policy, Department for Business, Innovation and Skills and **Mr Rory Earley**, Chief Executive, Capital for Enterprise Limited

Ev 1

List of written evidence

- | | | |
|---|--|-------|
| 1 | Capital for Enterprise Limited | Ev 12 |
| 2 | Department for Business, Innovation and Skills | Ev 13 |

List of Reports from the Committee of Public Accounts 2009–10

First Report	A second progress update on the administration of the Single Payments Scheme by the Rural Payments Agency	HC 98
Second Report	HM Revenue and Customs: Improving the Processing and Collection of Tax: Income Tax, Corporation Tax, Stamp Duty Land Tax and Tax Credits	HC 97
Third Report	Financial Management in the Foreign and Commonwealth Office	HC 164
Fourth Report	Highways Agency: Contracting for Highways Maintenance	HC 188
Fifth Report	Promoting Participation with the Historic Environment	HC 189
Sixth Report	Train to Gain: Developing the skills of the workforce	HC 248
Seventh Report	Young peoples sexual health: the National Chlamydia Screening Programme	HC 283
Eighth Report	Department for International Development: Aid to Malawi	HC 282
Ninth Report	The procurement of legal aid in England and Wales by the Legal Services Commission	HC 322
Tenth Report	Services for people with rheumatoid arthritis	HC 46
Eleventh Report	HM Revenue and Customs: Dealing with the tax obligations of older people	HC 141
Twelfth Report	Maintaining financial stability across the United Kingdom's banking system	HC 190
Thirteenth Report	Excess Votes 2008–09	HC 360
Fourteenth Report	Department for Transport: The failure of Metronet	HC 390
Fifteenth Report	Equality and Human Rights Commission	HC 124
Seventeenth Report	Department for Business, Innovation and Skills: Venture capital support to small businesses	HC 271

Oral evidence

Taken before the Committee of Public Accounts on Wednesday 13 January 2010

Members present:

Mr Edward Leigh, in the Chair

Mr Richard Bacon
Nigel Griffiths

Mr Austin Mitchell
Geraldine Smith

Mr Amyas Morse, Comptroller and Auditor General, **Mr Rob Prideaux**, Director, Parliamentary Relations, and **Mr Peter Gray**, Director, National Audit Office, gave evidence.

Mr Marius Gallaher, Alternate Treasury Officer of Accounts, HM Treasury, was in attendance.

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL VENTURE CAPITAL SUPPORT TO SMALL BUSINESSES (HC 23)

Witnesses: **Mr Simon Fraser**, Permanent Secretary, **Ms Emma Squire**, Deputy Director SME Finance Policy, Department for Business, Innovation and Skills and **Mr Rory Earley**, Chief Executive, Capital for Enterprise Limited, gave evidence.

Q1 Chairman: Good afternoon and welcome to the Committee of Public Accounts where today we are considering the Comptroller and Auditor General's Report *The Department for Business, Innovation and Skills: Venture capital support to small businesses*. We welcome back to our Committee Simon Fraser, the Department's Permanent Secretary. We also welcome Rory Earley, Chief Executive of Capital for Enterprise Limited. We were hoping to have this hearing last week but we were informed by the Permanent Secretary's Private Office that they did not want to come last week because it might have spoiled their Christmas, which we found surprising because it meant we lost a day for a hearing. But there we are. Happy New Year anyway. May I now refer you to paragraph 16 of the C&AG's Report, which you will be familiar with? There it says that you accept that the programme cannot currently demonstrate value for money. If we also look at paragraph 3.16 we will see that it took you from 2000 to 2008 to have an interim evaluation. Why has it taken so long for the Department to measure what we are getting out of these funds?

Mr Fraser: First of all, I do indeed agree with the findings and recommendations of the Report which are useful for the Department in evaluating these schemes. I do also agree with the conclusion that you alluded to that we cannot currently demonstrate the full value for money of these schemes. I am happy to talk further about that and explain that further in our discussions. In your point about why it has taken so long to launch interim evaluations, the fact is that schemes of this sort are fairly long-term operations. Characteristically you can only begin to evaluate the returns from these schemes after a period of about eight years and they come to maturity after a period of 10 to 12 years. Both these schemes were only started in 2000 and are now at the point at which we have been able to begin to do intermediate evaluation of the first sets of schemes and indeed we have done that.

Q2 Chairman: The interim evaluation, which it took eight years to come out with, was actually published on 10 December, exactly the same day that the NAO Report was published. It rather leads me to suspect that you only got on with this when the NAO were breathing down your back.

Mr Fraser: May I ask Ms Squire to comment on the timing of that precisely?

Ms Squire: It was always our intention to produce interim evaluation reports for Regional Venture Capital Funds and the Early Growth Funds around year six or seven. The reason we wait so long is because, while the fund might be six years' old, the number of investments that it makes will be made gradually over the first few years. At year six, whilst the oldest investments might be six years' old, the newest were only a few months' old. NESTA and BVCA, in their report last year, confirmed that year six or seven was about right for an interim evaluation.

Q3 Chairman: I can understand that it might take some time to evaluate these funds. What I cannot understand is why, when you set them up, you did not set specific economic objectives. If we look at paragraph 2.3 in the Comptroller and Auditor General's Report we see there "The Department has not, however, translated these aims into clear, prioritised objectives". If you did not set out the objectives then, are you now able to tell the Committee what you were trying to achieve?

Mr Fraser: The Report makes a number of valid observations about ways in which these schemes might have been better set up in their early stages, which reflects the fact that they were fairly innovative schemes. Certainly in relation to setting clear objectives, setting clear means for evaluating performance, as well as other things like transparency, there have been lessons learned and we have been able to improve the scheme. Certainly on

the new schemes we are putting in place—and Mr Earley will be able to comment in more detail than I on this, if you wish—we have introduced very clear objectives, both in terms of financial performance, much clearer evaluation mechanisms, also in terms of the economic impact of these funds which was of course an important objective for them and we have improved the transparency. A number of lessons have been learned and this Report very usefully brings them together in a way which helps the Department improve its performance.

Q4 Chairman: Are we going to lose money as a result of investing in these funds?

Mr Fraser: It is too early for us to be able to make a full judgment on the performance of the funds, for a number of reasons. First of all, as I said at the start, it is too early to be able to evaluate the performance; it takes time. There is a J-curve in the report which shows the sort of normal return period on funds of this sort. Second, on this question of value for money

Q5 Chairman: You loosely mentioned a J-curve. I think you are referring to figure 10. What figure 10 actually shows on page 25 is that these funds, which had no clear objective when they were set up, are actually performing poorly compared with their European counterparts.

Mr Fraser: Actually I was not referring to figure 10.

Q6 Chairman: Which J-curve were you referring to then?

Mr Fraser: Figure nine, which is a more general indication of the normal profile of returns.

Q7 Chairman: Can you also see figure 10?

Mr Fraser: I can see figure 10 which is giving some comparison with other funds. Would you like me to comment on figure 10?

Q8 Chairman: Yes.

Mr Fraser: On comparisons it is quite difficult because a number of comparisons are drawn in the Report, for example with commercial funds. This was the point I was going to make that we have to bear in mind that we were specifically addressing an equity gap with these funds, that is an area in which normal commercial funds were reluctant to invest, the reason being that these are relatively high risk areas.

Q9 Chairman: What are these? Are they an investment fund or just a grant to business? Which is it?

Mr Fraser: These are very clearly capital growth funds. May I ask Mr Earley to comment in more detail on the nature of the precise investment? They are certainly not grants to business.

Q10 Chairman: All right, they are not grants to business then. If they are not grants to business and they are investments, why was a rate of return not set at the beginning? If you are a bank and you wish to invest in a business, you plan from the start. At least

you have some idea what you hope your rate of return should be. There is a real suspicion here that this is in fact a slush fund to help business, it is a grant to business and it could well fall foul of EU state aid rules because they are not run as proper investments with a proper rate of return and a proper objective laid down at the beginning.

Mr Earley: It is true that there was no financial return objective set for the Regional Venture Capital Funds programme at the outset. However, each of the individual funds was set a target rate of return before or below which the investment fund manager could not share in the profits of the fund. Each individual fund was set a target rate of return which, for the Regional Venture Capital Funds, meant the return of all, both the Government's money and the private investors' money, plus a 10% return on the private investors' money. So there was a target for each individual fund. They are managed in a way which very clearly cannot be slush funds; the managers are incentivised and very carefully tasked.

Q11 Chairman: Let us now deal with fund managers; you mentioned them so let us deal with them. They are in the private sector and there are 28 fund managers, are there not? Is that right?

Mr Earley: There are 28 funds; some fund managers manage more than one fund.

Q12 Chairman: How many are there?

Mr Earley: I do not have that figure off the top of my head.

Q13 Chairman: They are in the private sector so they obviously manage other funds. I am told they get from the taxpayer between £50,000 and £90,000 for running the funds. Is that right?

Mr Earley: The salary levels, as surveyed by the NAO, are in that range and at the bottom of the range

Q14 Chairman: Why do you think it appropriate that 36% of the money invested goes to these fund managers? Thirty-six per cent of taxpayers' money designed to help struggling small businesses actually goes to wealthy fund managers.

Mr Earley: The Report points out that the fees paid for these funds are not out of line with the fees paid elsewhere.

Q15 Chairman: Do you think it appropriate that 36% of the money which is supposed to go to struggling businesses actually ends up in the pockets of your fund managers?

Mr Earley: The way the funds are structured, the money is not—

Q16 Chairman: I did not ask you about the way, I asked you whether you thought it was appropriate.

Mr Earley: You will be asking for a personal opinion there. I think this is a very hands-on activity which requires professional, expert people. It is not cheap and the Report recognises that.

Q17 Chairman: Would you please look at paragraph 2.10? You will see there that a very large proportion of these investments are made in London and the South East. Why do you think that is? Is it because about 50% of your fund managers actually live in London and the South East that a very large proportion of taxpayers' money is going to fund managers who live in London and the South East as opposed to helping businesses in the North West, North East, East Midlands or the West Midlands?

Mr Earley: May I point out that figure six shows there is not actually a great correlation between where the fund managers are based and where the investments are made? Our analysis shows that the investments across all these programmes map very well onto the map of regional GVA, so each region gets a very good share.

Q18 Chairman: It says here in this Report that Mr Fraser has signed up to "The distribution of investments under the national programmes has been concentrated in London and the South East".

Mr Earley: And regional GVA is concentrated in London and the South East.

Q19 Chairman: Yes, it has been concentrated there because 50% of the fund managers live in London and the South East.

Mr Earley: I do not think that is borne out by our analysis of the distribution.

Q20 Chairman: It is in the Report.

Mr Fraser: There are of course some different distributions of enterprises of this sort and there is a concentration in some regions. One also has to bear in mind that there are some specific regional funds operated by the RDAs in the North of England which are complementary to this activity. This not the entire picture of the availability of this sort of venture capital.

Q21 Chairman: Mr Earley, how can you justify the cumulative costs of managing these funds? When we look at paragraph 2.16 "While cumulative costs will continue to rise, final proportionate costs are not yet known". A scheme which started in 2000 and here we are at the beginning of 2010 and we read that cumulative costs will continue to rise and the final proportionate costs are still not known.

Mr Earley: The final proportion will only become clear as the funds mature, when we know all the money spent on fees, all the returns, all the money that has been invested.

Q22 Nigel Griffiths: I suppose the good news first is set out on page six that four out of five of the businesses reported that the initial funding made it easier for them to obtain additional finance, nearly one third reported that they would have been unable to obtain finance without support from the funds and between one fifth and a quarter say they would not have gone ahead with their planned activity in the absence of finance from the Department's funds. Do you have an assessment of the impact of these

venture funds in ameliorating any adverse problems arising in companies out of the recession and getting investment into companies?

Mr Fraser: We have begun the evaluation process and we have done the initial interim evaluation on the first schemes. They are beginning to give us some results on the economic benefits which are coming from the schemes. For example, the figure of an average of seven new jobs per company of those companies invested in by the schemes, given that they are small companies, is not inconsiderable. Forty-two per cent of these companies report that they have started or increased exports. Of the total number of companies invested in, 70% are still invested and are surviving companies, so those are all indications of the benefits that the schemes are beginning to or have given. In the online appendix three to the NAO Report there were some case studies which gave a bit more individual detail on some companies for the benefits that have derived.

Q23 Nigel Griffiths: You have explained to the Chairman and the Committee why it has taken some time to evaluate the impact of the funds. Has the Department been monitoring the investments from the beginning?

Mr Earley: Yes, we have been monitoring very closely all the investment programmes. We meet at least twice a year with each manager. We get portfolio reports on a quarterly and six-monthly basis, audited reports annually and we keep in very close touch with all the managers so we can address any issues of performance with the managers and keep a close eye on the performance of investments.

Q24 Nigel Griffiths: Point 13 on page eight makes the concerns of the NAO very clear about keeping information confidential. I can realise why you might not want to discuss the performance of individual companies, but I am not convinced there is a reason why you cannot give the performance of the portfolio.

Mr Fraser: Indeed, on this point, this is one of the areas where we have sought to improve transparency and there is now a new system on the website for reporting performance on the CFEL website.

Mr Earley: It is a recommendation we have accepted from the National Audit Office and we are now publishing aggregate data in a way which provides as much information as we think we can provide without compromising commercial confidentiality.

Q25 Nigel Griffiths: I must say that I would have found it helpful to have a memo to that effect for the Committee today. I do not know whether you are able to pick one of these funds and tell us how that looks.

Mr Earley: The data we are publishing does not go down to fund level; it breaks down the investment programme across funds, by regions, by sector and makes comparisons with industry data.

Q26 Nigel Griffiths: So it is very close to one of the tables in the Report on sector.

Mr Earley: Yes.

Q27 Nigel Griffiths: Why does it not go into what the return on the high technology fund looks like?

Mr Earley: The return to Government, the valuation of the Government's investment, is in the public domain.

Q28 Nigel Griffiths: No, how the fund is performing really.

Mr Earley: We are constrained in our ability to publish interim data on fund performance by the legal agreements we enter into when we invest in the funds.

Q29 Nigel Griffiths: Is this standard in venture capital funds?

Mr Earley: Absolutely standard; it is a requirement of the other investors in the funds as well as the fund managers.

Mr Fraser: We would be happy to provide you with a memo, if you like, on the transparency issues.¹

Q30 Nigel Griffiths: That would be helpful. The cumulative management fee costs do look on the very high side: 36% of the total value of the investment. Am I right in thinking that all of that cost is met by the Department?

Mr Earley: The cost of managing the funds is met by all the investors in each fund.

Q31 Nigel Griffiths: So the £46.1 million is shared roughly how? It depends on the fund I assume.

Mr Earley: Across the programme it is roughly 25%² of the value of the commitments to those funds.

Q32 Nigel Griffiths: So the taxpayers' contribution to that is £21 or £22 million.

Mr Earley: It will be a quarter for the Regional Venture Capital Funds.³

Q33 Nigel Griffiths: Are you accepting recommendation 17e that you "... include breakdowns of public and private sector investment to date"?

Mr Earley: Yes, that is included.

Q34 Nigel Griffiths: What have been the improvements which have come in the later funds, as touched on in the Report, to make them more effective? I think the later ones are the Enterprise Capital Funds and the Aspire Funds.

Mr Earley: The starkest example is the way that the government investment is structured. In the early funds, the Regional Venture Capital Funds, the government investment was subordinated so it absorbed the first share of any losses in the fund, it was drawn down first. In the later funds in the current programme, the Enterprise Capital Fund programme, the Government actually get their return first before the private investors but take a

limited share of the profits to provide a different sort of incentive for the private investors, one which better safeguards the government investment.

Q35 Nigel Griffiths: How have you been able to make that change? Presumably that would have been desirable early on? Was it the sort of thing which was vetoed by the likely investors in the early venture capital funds?

Mr Earley: The early programmes were very innovative; nothing had happened before and there was considered to be a pressing need to attract private sector investment, so there were more generous incentives to bring that investment in. It raised £3 of private investment for every £1 of government investment with a subordination that was there. In the later funds it is £1 of private investment for £2 of public investment. So the less generous subordination is less attractive to private investors but does better safeguard the Government.

Q36 Nigel Griffiths: Among the objectives, certain of three of the four funds, you have to demonstrate to investors and the venture capital industry that commercial returns can be made on an early stage. How are you able to do that when you are not releasing information because of commercial confidentiality?

Mr Earley: That is a recommendation which has been accepted and more information is being put in the public domain. The demonstration effect prior to that was only to those private investors who were involved in the fund.

Q37 Mr Bacon: You said to Mr Griffiths that across the funds the public sector was paying about 25% of the fees. Is that right?

Mr Earley: For the Regional Venture Capital Funds, the Department's investment accounts for about 25% of the total size of the funds at the outset, at inception,⁴ and the Department pay the same rate of fees as other investors in those funds.

Q38 Mr Bacon: If you take the total fees that have been paid, £46 million was the fee for the Regional Venture Capital Fund. If you take the total fees which are £73 million, what percentage of that would have been funded by the private sector and what percentage of that would have been funded by the public sector? In total.

Mr Earley: It differs for each programme.

Q39 Mr Bacon: What I am really asking is: what is the total amount of fees paid for by taxpayers?

Mr Earley: I would have to calculate that and come back to you on that precise figure.⁵

Q40 Mr Bacon: It does strike me also, as it did Mr Griffiths, as a very high number. Why is it so much higher in the Regional Venture Capital Funds than it is in the Technology or the Bridges Funds?

¹ Ev 13

² Note by witness: The correct figure is 29.7%

³ Note by witness: The correct figure is 29.7%

⁴ Note by witness: The correct figure is 29.7%

⁵ Ev 14

Mr Earley: The figures are presented as a proportion of the amounts invested and the Regional Venture Capital Funds have not invested as much as they were expected to at the outset. The fee levels were set on the expectation at the outset so the proportion is higher for those funds.

Q41 Mr Bacon: How much was expected to be invested? The chart at the beginning sets out in figure one the amount of £74.4 million as the government commitment, seven funds in 2002 and two funds in 2003 and the total raised was £226.5 million. Are you saying that a smaller proportion than expected of that £226 million was actually invested?

Mr Earley: Yes and more in some funds than others.

Q42 Mr Bacon: Of the £226 million in the Regional Venture Capital Funds that was to be invested, how much in total has been invested?

Mr Earley: Gross investment to 31 December 2008 was £132.8 million.

Q43 Mr Bacon: So nearly £100 million never got invested.

Mr Earley: The funds are still able to make follow-on investments in portfolio companies.

Q44 Mr Bacon: I am just asking, if you had £226.5 million for 2002 and 2003 onwards, you are saying that of that only £132 million was invested and nearly £100 million was not. I am just trying to understand. Is that correct?

Mr Earley: Has not yet.

Q45 Mr Bacon: Understood; has not yet. The point is that 2002 and 2003 was significantly before the credit crunch. The credit crunch did not really start until the autumn of 2007. I can understand why you might not necessarily want to invest during late 2007 or during 2008 when things were very turbulent, but what was going on in 2002, 2003, 2004, 2005 and 2006 when we had a boom economy that you did not invest this money?

Mr Earley: There are many reasons. If I could remind the Committee, these funds were innovative and experimental at the outset so there could be no certainty about how much they could invest over the following periods and they were based on analysis at the time by fund managers and by the regional development agencies but largely based on estimates of how much the fund managers could persuade the private investors that there was the opportunity to invest that much.

Q46 Mr Bacon: So they could only go ahead if they could get the right amount of funding from the private sector.

Mr Earley: Yes; absolutely.

Q47 Mr Bacon: Going back to the fees, you were saying they were basically frontloaded so that the fees which got paid to fund managers got paid on the basis that the assumption would be this £226 million would get invested.

Mr Earley: That is absolutely the industry standard way of calculating fees for the commitment periods of funds.

Q48 Mr Bacon: Regardless. I must say I find one thing odd. I used to act for a venture capitalist some time ago in a previous life and looking through the chart there were 247 surviving investments in this area out of a total of 356 investments made and average investment was £373,000.

Mr Earley: Yes.

Q49 Mr Bacon: I understand about the equity gap; this is gone into early in the Report where it quotes a 10-year-old assessment by the Department saying that the equity gap affected investments up to £500,000. Then further assessments were done saying it was between £250,000 and £2 million and indeed another one, again by the Department I think, saying between £100,000 and £2 million "A significant number of interviewees reported, however, that the problem may also affect businesses seeking amounts up to £5 million, which makes much more sense to me. You have £373,000 going into 356 businesses. The management time involved in monitoring those is obviously going to be very significant. What really struck me about this was the piddling size of the sums invested which is not actually going to do that much good in a business if you are only going to be putting in a few hundred thousand. Why has so little gone in to such a large number of businesses making management almost impossible and making it difficult to give amounts of equity which make a difference to good businesses?"

Mr Earley: The first point, if I may, is that the heavy burden of managing and monitoring the investment is one of the reasons why the fees are so high on these funds; they are expensive to run. Second, and more importantly in answer to your question, is that the funds were set up with constraints which were the result of a public consultation by the Department and by European state aid rules at the time. European state aid rules constrained the funds to investing no more than £500,000 in two tranches of £250,000 into these companies. We have subsequently managed to renegotiate relaxations of that with the Commission for the very reasons you mentioned. In hindsight, it has become very obvious that those constraints were far too tight to enable these funds to make good commercial returns.

The Committee suspended from 4pm to 4.06pm for a division in the House.

Q50 Mr Bacon: Mr Earley, you were talking about the European Union limiting the investment to £500,000 on the grounds of state aid. Which commissioner was it who was doing that? Which bit was responsible?

Mr Earley: The Director General Competition.

Q51 Mr Bacon: If the Chairman was right that these were investment funds and not grants why would that necessarily have been relevant? If they had been done on a like-for-like basis with private sector funds, why would that have mattered?

Mr Earley: Because at the time the Commission, DG Competition, considered public money in the funds to be state aid or to have a risk of being used as a subsidy mechanism and therefore wanted to control them.

Q52 Mr Bacon: Given they managed to turn £74 million into £5 million they may have had a point, may they not?

Mr Earley: A current valuation of £5 million. The way the funds are structured means that they are delivered commercially by private sector fund managers who are incentivised to make financial returns on the schemes.

Q53 Mr Bacon: Indeed they have done very well out of it. This is what I find extraordinary. You have managed to turn £74 million into a current—you are right—valuation of £5 million, while the fund managers have managed to make £46 million out of it. It just seems quite extraordinary that they have been rewarded when there has not been the performance. I can understand why you might reward them for high performance but, the way the fee structure seems to have been operated, they were rewarded whether or not there was performance, were they not?

Mr Earley: Their costs are funded whether or not there is performance. There is no performance incentive unless they perform above the targets which were set which they have not done. There is no performance payment to fund managers but the cost of managing the funds are covered.

Q54 Mr Bacon: Yes, but they have still done all right: 36% of the total money invested was management fees. That is almost unconscionable. I could have turned £74 million into £5 million for a lot less than £46 million in fees. Austin would have done it quicker, as he has just told me. Why did not somebody say at the outset “If this is the best that you can do and if really it is going to be limited to £500,000, then there is not a lot of point in doing it”?

Mr Fraser: One of the important things about this hearing is the lessons we have learned through the experience over the years of managing these funds. Two of the lessons we have learned most clearly are that the model of lots of different regional funds was not the most appropriate model, not the most efficient model, not the most cost-effective model. Secondly, the size of the investments, as you rightly identified, should not be limited to such small amounts. Indeed the academic analysis of where the equity gap lies has evolved over the years so that the more recent funds we have launched are both national in scope and encourage larger investments and therefore are more efficient in terms of management.

Q55 Mr Bacon: I appreciate those things have been learned and I am glad you said that. What I do not understand is why you had to go through this expensive process in order to learn them. I could have told you, as somebody who only acted as a PR for a venture capital fund, that things like deal flow,

the timing of the investments, the broad geographic spread, larger fund sizes and the ability to make follow-on investments and individual exits on a timely basis were important. Did you really have to spend so much taxpayers’ money to find out what you could have found out, if not in one phone call, then in a few one-hour meetings with some venture capitalists.

Mr Fraser: We are seeking to achieve policy objectives in areas where normal commercial funds were not engaging.

Q56 Mr Bacon: If that is the case, why is it all in the South East? This reminds me of the Commonwealth Development Corporation.

Mr Fraser: The regional funds, by definition, are not all in the South East.

Q57 Mr Bacon: I was not just talking about the regional in this case; I was talking about all of them. The Chairman referred to paragraph 2.10 which stated that the concentration of investments under the national programmes has been in London and the South East. If you are seeking to achieve policy objectives, it reminds me of the Commonwealth Development Corporation where they did very well by investing in growing markets like China and India. If you invest in London and the South East you might expect that it is easier to find good investment than if you go into harder-to-find-good-businesses areas. In a sense, is paragraph 2.10 just mimicking what other venture capitalists would say?

Mr Fraser: Mr Earley has pointed out that in fact the distribution of investment is not all in the South East, even if the fund managers are located in the South East. Quite clearly we are not mimicking what is available through commercial investors.

Q58 Mr Bacon: Forty-three per cent of the businesses they invested in were in London and the South East. That is what it says in paragraph 2.10, so by far the most is just in those two regions.

Mr Fraser: That does not reflect the figure which Mr Earley gave to you earlier on.

Q59 Mr Bacon: It is in the Report. May I just check with the NAO? This is an agreed Report is it not?

Mr Gray: Yes, it is.

Q60 Mr Bacon: It is an agreed Report.

Mr Fraser: Yes, that is true. You are referring there to the national programmes.

Q61 Mr Bacon: Yes.

Mr Fraser: Indeed in so far as we have identified that there is risk of concentration in the South East, we are seeking to ensure that there is an appropriate regional distribution. I take your point. In fact last week Lord Mandelson asked Lord Davies of Abersoch to report to him on this whole point about ensuring that there is an effective national programme, which I think is what the Report is seeking for us to have, but also ensuring that there is a proper and effective pipeline of regional investment. In addition, I would draw your

attention again to the fact that there are existing schemes, also run by the RDAs as regional schemes, which are not covered in these national programmes.

Q62 Mr Bacon: Mr Earley mentioned the fact that the businesses in the regional scheme were currently valued at £5 million. In total figure 11 says there are 576 surviving businesses. I do not necessarily expect you to publish this on a broken-down business-by-business basis but have you done some analysis of what those 576 surviving businesses are worth or might be worth or might be worth going forward?

Mr Earley: Yes, we have. Every year the funds are required to value each individual portfolio company and to have those valuations audited against industry standard valuation guidelines. We also asked the fund managers for their best estimations of the maximum and minimum exit values for each of those invested-in companies so we can have an ongoing assessment of the likely returns to all investors in the funds. It is important to point out as well that it is the Department's investment, which I explained earlier was subordinated, which is reduced from £74 million to £5.9 million. The private investor investment in the funds ranges from an IRR currently of 10% through to 2 funds which are slightly negative.

Q63 Mr Bacon: But because of the way it was structured you take the hit first.

Mr Earley: Yes; exactly.

Q64 Mr Bacon: How much of the information you have just been talking about is published or is it all for your own internal consumption?

Mr Earley: Most of it is for reporting to the Department so they can understand in full what the investment portfolios are doing. We are very happy to report as much detail as the Committee would like in confidence to the Committee. We are constrained as to how much we can put in the public domain. We are putting as much as we possibly can in at the moment without compromising those agreements.

Q65 Mr Bacon: Really what I am getting at is, of those 576 businesses, do you think you are looking at some golden acorns that in five, eight, 12 years' time will be making the taxpayer very happy?

Mr Earley: We very much hope so.

Q66 Mr Bacon: What is your analysis? Does your analysis suggest that is the case?

Mr Earley: Our analysis suggests that there are some really potentially fantastically successful businesses in the portfolio. Whether or not that potential can be realised in current economic circumstances is what we pay the managers for. They have to work very hard to realise the potential of the investment. As you know, with venture capital very few investments generate returns to the funds.

Q67 Mr Bacon: May I just go back to the size of the investment? You said that the EU have now recognised that £500,000 is really far too low and if

the equity gap is really up to £5 million then one presumes that the ceiling ought to be roughly of that order. What is the EU ceiling now?

Mr Earley: I believe the current EU ceiling is €1.5 million. For our current programme we have persuaded the European Commission that because of the way it is structured, with the Department taking less risk than private investors, they will allow investments up to £2 million per investee company and follow-on investment up to 10% of the total value of the fund. We think we have a better commercial understanding from the Commission than the general rules elsewhere.

Q68 Mr Bacon: Am I to take it that you now take the view that it would be better to put larger sums into a much smaller number of businesses, not necessarily just a handful but, instead of 576 or a total of 810 invested in, that it might have been better to have invested a lot more in, say, 70 or 80 businesses?

Mr Earley: Yes, but we need to bear in mind that these are funds to address the equity gap where private investors will not invest and there is certainly evidence that private investment funds invest in *tranches* above £5 million and certainly some between £2 million and £5 million. It would be wrong of the Government to displace private sector investment.

Mr Fraser: We are in fact seeking to rationalise the programme going forward so that we have a fund looking at smaller investments. We also have the UK Innovation and Investment Fund which has just been launched which is looking at slightly larger figures, particularly in the high tech sector and that is, *pari passu*, investment which is not subject to state aid. We are also considering the Rowlands report on growth capital which is slightly larger amounts for growth rather than start-up and we are at present working on the establishment of a fund to support that area of the market. We are seeking to rationalise but to be able to address different parts of the venture capital market.

Q69 Mr Mitchell: Continuing the theme of fees for the investment advisers, what were the fees paid to them for? Were they paid for coming to a deal or were they paid for getting private capital in or were they paid on the basis of the success of that particular deal?

Mr Earley: The fees are paid for managing the fund, which is raising the fund, structuring the fund, attracting the private investor, finding the investments, structuring the investments, making and monitoring the investments.

Q70 Mr Mitchell: So it is for coming to the deal.

Mr Earley: It is for coming to the deal; it is also for assisting the development of the business, assisting the additional financing of the business and exiting the business.

Q71 Mr Mitchell: You will not know that until the end of the period, will you? Is a fee paid as soon as a deal is come to and then another fee for assisting and supervising?

Mr Earley: No, there is a flat rate fee which is structured as a percentage of the commitments to the fund which is paid quarterly in advance of the fund managers throughout the commitment

Q72 Mr Mitchell: So you assume that they are continuing to assist and supervise.

Mr Earley: Yes and we monitor them very closely to ensure that they are and where they are not acting at the rate we expect them to be acting, we have taken action in the past and reduced fund sizes and had rebates and reductions in fees.

Q73 Mr Mitchell: Are they paid in any other way or are they just paid on a fee basis?

Mr Earley: Some funds also take—

Q74 Mr Mitchell: No, I mean the advisers. Are the advisers paid in any other way than fees?

Mr Earley: The fund managers are paid in fees and sometimes they take a fee from the underlying company as well but we take those into account in the totality of income to the fund manager.

Mr Fraser: This is covered in paragraph 3.10.

Q75 Mr Mitchell: So they get it both ways.

Mr Earley: No, because if they are taking a good deal of money from the underlying companies, we would say that is actually damaging the prospects of the underlying company and we would take that into account anyway in the fees they pay.

Q76 Mr Mitchell: Who are these jokers, the fund managers? How do you pick them?

Mr Earley: There are an awful lot of organisations who would like to be fund managers in this area. We are very careful to learn from historic performance and we pick fund managers who can demonstrate an ability to perform well in this area; stable, competent, well motivated teams, ideally with a track record, if not collectively then certainly individually.

Q77 Mr Mitchell: You pick them on the basis of their past performance as reviewed by you.

Mr Earley: Yes.

Q78 Mr Mitchell: What instructions are they given to be cautious with public money? What are they told their brief is?

Mr Earley: Their brief is to maximise the returns from the investments they make within the constraints which are set by the legal agreements governing the operation of the funds.

Q79 Mr Mitchell: At the end of the period, assuming the investment is successful, you said to Mr Bacon that you had some golden acorns. By the same token, you must also have some disasters. Is any account taken of either in an ultimate figure?

Mr Earley: We expect a high number of write-offs in the funds and for those write-offs to come earlier in the life of the funds.

Q80 Mr Mitchell: Do you then deduct from the fund manager's fee?

Mr Earley: No, but after the investment period the fees are based on the value of the existing investment. So the higher the number of write-offs early in the life of the funds the lower the fees are going forward in the funds.

Q81 Mr Mitchell: So it is a bit like a banker: he gets the money whatever he does, whether he succeeds or he fails.

Mr Earley: That is not necessarily the case. There is no performance incentive unless performance is delivered and fees after the first five years generally in the fund are based on the existing investment. So where investments have failed, if there have been large numbers of failures, then the fees will drop significantly after the first five years.

Q82 Mr Mitchell: You were talking about Europe. Are there similar funds governmentally financed in European countries?

Mr Earley: There are in most developed economies and appendix two of the Report is a study from Professor Gordon Murray which looks at a number of those programmes.

Q83 Mr Mitchell: Are they more generous or meaner than ours? Taken by country, how do they do in France and Germany?

Mr Earley: Some are more generous. It is difficult to be precise because very, very few have been evaluated and those evaluations which have taken place are not in the public domain. I know certainly that there have been equity guarantee schemes, so some Member States' governments have guaranteed these investments.

Q84 Mr Mitchell: Which countries do that?

Mr Earley: We believe that there is a guarantee scheme in Germany and I believe the German Government is talking about a new guarantee scheme which I read about last Friday.

Q85 Mr Mitchell: Are you talking there about national federal government or about the Länder?

Mr Earley: National government I believe.

Q86 Mr Mitchell: The Länder presumably does the same thing as well.

Mr Earley: I am afraid I cannot comment on that.

Q87 Mr Mitchell: Do you know or not?

Mr Earley: We do not know.

Q88 Mr Mitchell: So they could be smuggling large sums to start-ups which we do not know about.

Mr Earley: That is why the European Commission Director General Competition is so wary about the use of these funds as subsidy mechanisms and that is why they set such tight rules concerning the activities.

Q89 Mr Mitchell: It does not seem to have been very effective in policing the Länder, does it so far? In other matters I mean.

Mr Earley: I cannot comment on that.

Q90 Mr Mitchell: You were talking with Mr Bacon about European restrictions on state aids to industry. Do I conclude from what you were saying that that threat hanging over us has meant that you have opted for a lot more small loans than for big investments?

Mr Earley: As I think I mentioned earlier, we have been very successful at maximising the scope for these investment programmes under the state aid rules.

Q91 Mr Mitchell: Which has restricted you to fairly small sums.

Mr Earley: Yes, relatively small sums in the equity gap.

Q92 Mr Mitchell: That must have restricted the effectiveness of the funding system in the sense that probably bigger investment in a bigger start-up would have made a bigger return.

Mr Earley: That is one of the lessons learned from the early programmes that we have adopted for the later programmes so that the funds can make larger investments in smaller numbers of businesses.

Q93 Mr Mitchell: Has the EU restricted you from doing that on the scale you would have wanted?

Mr Earley: It has accepted arguments that the equity gap is larger than it had previously been prepared to accept and it has allowed our current programme to invest up to £2 million.

Q94 Mr Mitchell: Do you have any feeling, as I always believe as a matter of religion, that they are tougher on us than they are on France or Germany?

Mr Earley: The evidence is that they have been more generous to us on this programme than they have in general.

Mr Fraser: This is a policy matter with which Ms Squire may be able to help you.

Ms Squire: Last year we refreshed our analysis of the size of the equity gap and we concluded that the equity gap is most acute between £250,000 and £2 million but it may go much higher for sectors which have particularly high capital expenditure or long lead times before they start to generate returns. We were successful in negotiating with the Commission a special state aid dispensation to allow us to make investments of up to £2 million under the Enterprise Capital Funds programme and we have now the UK Innovation Investment Fund which will make larger investments and it is able to do that because it is not a state aid because we are not giving any advantage at all to private sector investors.

Q95 Mr Mitchell: I get the impression from this Report and from the fact that there is such a plethora of funds and not one simple straightforward structure that you have not behaved like those lunatics we have watched on television breaking the ice in the last few weeks and leaping into the cold water. You have put your toe in, gone into it very cautiously and gingerly and that has made the whole process messier and slower and more difficult than it should really have been.

Mr Fraser: It is appropriate for us to be cautious when we are in innovative areas of policy involving public money. I could imagine that if we had done this a different way and things had gone wrong I might be facing a different set of questions from you. You are absolutely right that what we need to do is to learn from the experience that we have. We do have to remember that we are still at the fairly early stage in this because of the time periods on which investments of this sort are going to realise returns. Now is the time for us to be learning the lessons of the initial experiment, which I fully accept is not in every respect a total success. We have lessons to learn both in terms of the structure of the schemes, the way that we set objectives, the way that we evaluate them, including making sure that we take full account of the economic benefits of the schemes as well as the financial performance of the funds, which is a policy issue which is very important for the Department, and the impact on businesses. There is a lot for us to learn and we are seeking to learn those lessons.

Q96 Mr Mitchell: If the problem of venture capital and start-up capital, which is certainly worse here than it is in America; I don't know about European comparisons but one always reads that the position is not very good in this country, if that is true, then you need to get in big and you need to get in quick, do you not, rather than this ginger stuff?

Mr Fraser: Absolutely.

Q97 Mr Mitchell: The Report says—I am quoting from page six, Findings, paragraph six—“The Department failed to establish a robust framework of objectives, and associated baselines, to enable it to judge whether the taxpayers' investment offered value for money. The Department has set multiple aims for each fund but these have not been translated into clear measurable objectives” and it goes on like that. In other words, you have not learned in the way you have said you are learning.

Mr Fraser: That is a comment on our earlier performance and those are lessons with which we fully agree and we are learning those lessons. In relation to the United States, the United States have been involved in this since 1958 when they set up their equivalent scheme. They have more experience and they are more advanced. In fact in the United States the amount of public money which is going into this sort of support as a proportion of GDP is 2.5 times what it is in this country. They are advanced on this. Within Europe it is generally recognised that we are at the forefront in innovating in this area now. We are learning lessons. NESTA, for example, who have done a review of our schemes,

have commented—and I think it is actually quoted in this Report—that the lessons which have been learned and the way that we have adapted to those lessons is actually something which they identify for a degree of praise.

Q98 Mr Mitchell: Do you think the structure is too complicated and that you have too many funds handing out piddling sums?

Mr Fraser: We had had too many funds and they have been set up in a way which is not the most effective. We are seeking to streamline and rationalise that into a more coherent programme with some funds looking at small investments. The Innovation and Investment Fund is looking at the larger investments, particularly in high tech, which is something we all agree is an economic area we need to be concentrating on and now the most recent development is the Rowlands review of growth capital for SMEs who are at a further stage of their development, which is between £2 million and £10 million, where he identifies a gap of about 5,000 companies a year seeking an injection of capital support and we are now working to seek to address that. We will have a coherent, more structured, less diverse and better organised range of programmes put together and managed in a more effective way.

Q99 Mr Mitchell: It came out in Mr Bacon's questioning that the take-up was slow in what you would call the fat years when the economy was growing. Now the economy is not, we are in the thin years, a situation where bank credit seems to be too tight. Are you expecting to step up the amount of money and the activity of these funds now?

Mr Fraser: That is absolutely what we are doing. Interestingly I was at Imperial College yesterday talking to Imperial Innovations, which is their venture capital scheme. They said quite clearly that private sector equity in this area is in retreat at present because people are risk averse. As you have identified, bank lending is more difficult for small enterprises to get, which is why our Department actually, since this crisis, has put in place a number of schemes to try to promote bank lending, our Real Help Now schemes. In addition, we have launched this year a new Innovation Investment Fund which now has £325 million of funding and will be available for lending in 2010. We are now working on raising a further growth capital fund to supplement this. We have identified that there is an acute need now and luckily we have the learning of the past to help us address this more effectively.

Q100 Mr Mitchell: I am glad to hear it. I am a devoted regional man because I live in a region. I was concerned to see on page seven of the Report, paragraph eight, that the return on the High Technology Funds was minus 9.7%, the return on the Regional Venture Capital Funds was minus 15.7% with all nine funds showing negative returns. Why are you doing worst in the regions where you should actually be doing more in my view than in the fat South East where all the fund managers and money are concentrated anyway?

Mr Earley: The Report recognises that the performance of those funds was affected by the constraints under which they had to operate, partly because of European Commission state aid rules. The performance of the Regional Venture Capital Funds is largely as a result, as the Report recognises, of the constraints under which they had to operate. There are still some very good quality investments coming out of those Regional Venture Capital Funds and some very good quality exits.

Q101 Geraldine Smith: The success of the funds must be dependent on spotting and supporting high growth companies. How does that work in practice? How much is left to the fund managers to identify the companies? Do you have anything to do with that?

Mr Earley: It is all entirely in the hands of the fund managers. They are paid to identify and nurture good quality investments.

Q102 Geraldine Smith: So if I, as an MP, said "Brilliant business in my constituency" there would be no chance; it is down to fund managers to make that decision.

Mr Earley: Yes.

Q103 Geraldine Smith: The crucial thing which seems to be missing is the information on how you compare the funds you have. How do we know? You have 28 funds, which you have accepted is probably too many and should be a smaller number. How do we know which ones are working well and which ones are not working so well? What do you do? I understand that it is a long-term investment and you are just coming to a stage where you can perhaps look at it.

Mr Fraser: May I just point out this thing about the funds is that some of these funds are legacy funds? They are not all open. Once you have got a fund there, even if it is now closed for investment, it still exists, it still has investments in companies, so you cannot just close a fund down and the process of rationalisation is going to take us some time. On the actual monitoring of the performance of the funds . . .

Mr Earley: We monitor every fund very closely, we look at their performance, we benchmark them against each other, we report that information to the Department quarterly and our role is, where there is serious underperformance, to do something about it. The Report recognises where we have had reductions in fees, reductions in fund sizes and rebates in fees, where we have been seriously concerned about the performance of some of the funds.

Mr Fraser: May I pick up one point? You are touching on a really important issue for us here which is that it is normal, in funds of this sort, for investments to fail. About 10% of your investments will deliver—and this is in a commercial fund or any fund—about 80% of your return. We have to be able to accept that there will be failure. This is a very important issue for us in terms of our stewardship of public funds. What we are trying to do is to make

sure that the 10% that succeed more than compensate for those that fail or are less successful. The problem, as Rory has identified, is that the failures tend to come earlier and the big successes may come later and one big success may wipe out a lot of the failures. This comes back to the Chairman's early point about not knowing what the proportion of fees is against the overall performance of the fund. Until you know what the fund has actually delivered after 12 or 15 years you cannot tell. The fees may be completely absorbed in a tremendous return; they may not. One has to reserve judgment on some of these.

Q104 Geraldine Smith: Basically the fund managers received their fees, you cannot really tell, it is still too early and the information is not available to the public, so we cannot really see how the funds are operating. I can understand about the individual business but I cannot understand why the information about the funds is not available. You say you monitor them but can we see? Why can we not see that information? Some of those funds might be really quite abysmal and someone will still be getting fees, yet some might be doing quite well. I just do not know that.

Mr Earley: I am very happy to write to the Committee with a summary of the performance of all the funds. The constraint is on making that information available to the public. It obviously is available to Parliament; we can make that available to the Committee.

Q105 Geraldine Smith: To me that seems really crucial to tell how well you are doing.

Mr Fraser: Of course these are commercial investments so we have to accept that there are some constraints on the information which can be made available from the point of view of the companies themselves and their competitive positions; within those constraints.

Q106 Geraldine Smith: Some of those funds are drawing in private sector funding as well.

Mr Fraser: Of course, so there is the issue of the company and the private sector investors who all have interests at stake.

Q107 Geraldine Smith: Can you just remind me? Are the private sector investors taking on far less risk?

Mr Earley: In the early programmes, the Regional Venture Capital Funds, the private sector does have much less risk. In the current programmes we reversed that and the Government have less risk but the private sector will take a greater share of the profits when the funds are successful.

Q108 Geraldine Smith: I guess it is difficult, without looking at the funds and comparing and seeing how well you are doing, but certainly the principle is right; you should be supporting business in this way. Why does venture capital not exist for some of these companies? Is it just that they are considered too great a risk? Why does the private sector not do it anyway?

Mr Fraser: I think it is a question of risk. These are high risk ventures. If you can get a safer return elsewhere, why go there? If your sole motive is commercial and financial why go there. There is a policy issue which is to try to promote certain areas of development, dynamism, productivity in the economy, so we are slightly different. There is a public policy interest. Actually there is a recent study, which again is promoted by NESTA, which identifies this. An expert from Harvard, Josh Lerner, has said quite clearly in a recent study that the evidence is that without government intervention funding just does not come; these sorts of investment just do not take place. There is a broad acceptance that there is a role for Government. Our job is to manage it, to do it as well as we can and we accept that there are improvements we can make.

Q109 Geraldine Smith: How do you decide? I suppose the dilemma is how you decide when the private sector will not take part because it is too risky. How do you decide it is maybe too risky for the taxpayer as well because there is so little chance of success?

Mr Fraser: That is indeed the very important policy issue. That is why we do have to accept that there is a risk of failure and that not all failure is necessarily a bad thing. We have to look at where it does not succeed and where it does succeed and try to get the balance right. Of course the other thing is that we are seeking here to draw private sector investment in; that is part of the objective. So we are saying "We will put so much money up if you put up so much". For example, in the Innovation Investment Fund, we are seeking matched funding; our money is conditional on funding from private sources. We are creating a bigger pool of funding for these enterprises and we are taking some of the risk.

Q110 Geraldine Smith: You say 28 different funds are perhaps too many and you are looking at rationalising those. You also mentioned that the Regional Development Agencies have their own funds. Who is looking at those?

Mr Fraser: There are three RDAs who have funds which are actually deploying money from the European Union. It is the European Regional Development Fund money available to regions. So three of the RDAs have pooled funds which they are managing regionally to deploy those resources. It is very important—and indeed the Report says that we are achieving this—that we achieve complementarity between the national funds and the regional funds so we do not get dead weight and duplication. I think the Report is satisfied that broadly speaking that is taking place. Last year we agreed a national framework to improve the sharing of information and coordination as between the regional and national funds. Those funds exist because that is the way the European Union regional development money is made available so we have to work with that as best we can.

Ms Squire: Just to clarify, all of the Regional Development Agencies have funds. The three RDAs in the North West, North East and Yorkshire and

Humber have particularly large funds which are match funded by EIB's loan money and they were able to do that because they receive a larger proportion of the European Regional Development Fund. All nine RDAs do something in this area.

Q111 Geraldine Smith: So those funds will be specifically for business in that region.

Ms Squire: That is right and that is a condition of the European Structural Fund money which of course has slightly different objectives to the BIS-led funds because it is also about economic regeneration and convergence as well as about boosting productivity, which is the focus of all the BIS programmes.

Mr Fraser: The managing authority on those programmes is the Department for Communities and Local Government and we work with them.

Q112 Geraldine Smith: I am very curious to think how the fund managers find the business. I suppose they are in a very powerful position, are they not, as to who they allocate money to and who they do not?

Mr Earley: Yes. To identify the best opportunities to invest in to maximise the returns is the skill we pay them for.

Q113 Geraldine Smith: And I guess it is still too early to say how successful it has been.

Mr Earley: Yes.

Mr Morse: They cannot just make these decisions arbitrarily, they would have to have a business case. This is a difficult area because quite often Government is the undertaker or the investor of last resort. Being able to show that you are doing it in order to optimise the return is striking that balance between policy, being the investor of last resort and yet optimising commercial practice. It is a difficult balance.

Geraldine Smith: Yes, I can understand it; it is very difficult.

Q114 Mr Bacon: The future of the RDAs is not certain. If there were a change of Government, it is possible that the RDAs, or some of them, would go. It is also possible that the function which you have just described which currently sits in the RDAs would continue or that the Government might want it to continue. Do you have a contingency plan for where it might sit were there no RDAs but you wanted this activity to continue?

Mr Fraser: Of course there are functions to be conducted at the national, regional and local level and any government will have to consider most effectively how they wish to conduct them. It is clear

that this money is available at the European level for regional economic development or regeneration and we will have to find effective ways of doing that. Currently they are managed by the RDAs.

Q115 Mr Bacon: What is the answer to my question?

Mr Fraser: The answer to your question is that I hope that government, whichever government should be in place after the next election, would ensure that effective means are in place to continue the effective management of these schemes.

Q116 Mr Bacon: I am relieved to know it. Mr Earley, you mentioned Josh Lerner at Harvard.

Mr Earley: Yes.

Q117 Mr Bacon: Is it possible you could send us just a half page or page detailed summary of the points you were making and perhaps with a select bibliography of the articles and papers he has written on this subject where he is referring to the importance. Presumably this is a research specialism of his, is it?

Mr Earley: Yes, it is. He is probably the world's leading academic researcher on venture capital, so I am afraid his bibliography will be rather longer than one page.

Q118 Mr Bacon: Indeed. If you could send us some details and also where else to go, we could publish it in our appendix and that would be very helpful.⁶

Mr Earley: Yes.

Q119 Chairman: That concludes our hearing. I am afraid this is not a good Report, which even your great charm cannot quite cover up. Will you now commit to us to evaluate this programme fully within the next two years and return to us so we can know whether it is delivering good value for money?

Mr Fraser: I certainly commit to agreeing with the findings and accepting the recommendations of the Report. If I may, I do not share your judgment of the Report overall. I think it is a balanced Report, which certainly identifies areas for improvement and I accept that. We are very happy to come back before the Committee. I hope that in two years' time we will be better able to demonstrate value for money, which currently we cannot do, but of course I do reiterate that all these funds will take some time to mature. We should have a better picture in a couple of years' time certainly.

Chairman: Thank you very much Mr Fraser. That concludes our hearing.

⁶ Ev 15

Memorandum from Capital for Enterprise Limited

THE DEPARTMENT FOR BUSINESS, INNOVATION AND SKILLS: VENTURE CAPITAL SUPPORT TO SMALL BUSINESS

The Committee is meeting at 3.30 pm on Wednesday 13 January 2009 to take oral evidence on the Comptroller and Auditor General's report above.

Since the publication of the report, there has been one interesting development relevant to the observation in Recommendation c at paragraph 16 of the report. That observation is that the Department's approach is not yet demonstrated through successful exits of investments from funds.

The Committee might be interested in the attached press notice which highlights a recent exit from one of the Regional Venture Capital Funds. Not only does this exit provide a significant financial return in relation to the size of that fund, it is also an investment which is generating additional benefit to the taxpayer through savings to the NHS.

I thought it would be helpful to bring this to the Committee's attention in advance of the hearing.

Annex

ADVANTAGE GROWTH FUND EXITS SCRIPTSWITCH GENERATING STELLAR RETURN FOR ITS INVESTORS

Midven is delighted to announce the sale of Scriptswitch to United Health UK ("UHUK"), part of United Health Group Inc, a US quoted global health and wellbeing company. The transaction value is undisclosed, however Midven's Advantage Growth Fund has exited in full.

ScriptSwitch is the leading provider of software designed to support GPs with patient safety information, drug switch recommendations and dosage optimisation information at the point of prescribing.

Its success in boosting patient safety as well as driving cost savings on prescribed drugs has meant that it is now used by more than 60% of Primary Care Organisations in the UK. Annualised savings to the NHS as a result of decisions made by GPs, supported by ScriptSwitch are set to exceed £20 million.

Midven invested in Scriptswitch in 2003 through its Advantage Growth Fund at a time when the Company was still largely focused on product development, had minimal sales and was operating without a fully fledged management team. Midven worked closely with the Company during this formative years and the number of patients with access to the Scriptswitch service has grown significantly.

Tony Stott, CEO of Midven commented "This transaction is evidence that returns can be made from investing in start-up technology businesses and demonstrates that when managed appropriately by an experienced and focused fund manager the Government backed Regional Venture Capital Fund model should generate good returns for its investors."

The sale marks the end of a very successful year for ScriptSwitch. In April 2009 the business was awarded a Queens Award for Enterprise in the Innovation category. More recently, Mike Washburn, CEO was announced as the BVCA (British Private Equity and Venture Capital Association) "Venture Capital Backed CEO of the Year".

Mike Washburn, comments:

"Midven have supported the team in helping us develop and build the business over recent years. I'm looking forward to the next phase in our development, confident that we've built a robust and scalable business".

EDITORS' NOTES

Midven Limited is a privately owned company with a successful track record of investing in small and medium-sized enterprises in the Midlands. The funds it manages have invested in a wide variety of sectors, including software, biotechnology, healthcare, engineering, manufacturing and distribution.

The £17.5 million Advantage Growth Fund was launched in February 2003 by Advantage West Midlands to invest venture capital in small and medium sized companies in the West Midlands. Managed by Midven Limited, its investors include Barclays Bank, the Royal Bank of Scotland, HSBC, the European Investment Fund, local universities and the Department for Business, Innovation and Skills.

Letter from Permanent Secretary, Department for Business, Innovation and Skills

NAO REPORT—VENTURE CAPITAL SUPPORT TO SMALL BUSINESSES

Thank you for forwarding the transcript of the PAC hearing. I attach a copy with a few changes, broadly typographical amendments, and one note of a correction to the transcript.

Mr Earley wishes to amend his statement to Mr Griffiths at Q31 and Q32, and to Mr Bacon at Q37. This was incorrect. Mr Earley gave a figure on the proportion of the fees which could nominally be attributed to the taxpayer which was an estimate prior to the RVCF programme launching. The correct figure for the programme at inception is 29.7%.

The committee requested further information which I am happy to provide. Mr Griffiths asked about the transparency of the funds. Capital for Enterprise Limited has identified the need to publicise better the performance of the Department's fund investments and to this end has provided a breakdown on the funds

on its website, with regional analyses and benchmarking data. CfEL has also extended the information about its activities on the website; begun to issue a quarterly email newsletter to some 450 interested parties in the sector; and sponsored awards and events for female entrepreneurs to promote the Aspire Fund.

Mr Bacon was interested in the fees paid to the fund managers. Fund managers provide a source of general business advice, help recipient businesses raise additional finance elsewhere and assist in the development of business and marketing plans and the recruitment of key staff, often taking a seat on the Board of invested companies. One case study states that:

“I ring our Non-Executive Director several times a week to bounce ideas off him or to get his take on things. I find that side of it very valuable—it has been almost as valuable as the money. This is something we didn’t anticipate when we applied for the funding”.

(BERR RVCF and EGF Interim Evaluation: July 2009).

In the interim economic assessment of the RVCF and EGF programmes, 61% of respondents held the view that the assistance received from their Fund Manager had been of significant or notable benefit. It is this intensive support that the small cadre of firms with substantial potential require to succeed.

I attach further details of the fees paid by the tax payer and details of the financial performance of the funds. The information provided is in a format that we believe does not breach our confidentiality obligations and gives full details of the capital committed, drawn-down and invested, together with the value of the portfolio and the net realised gains and losses for each programme. The information is not broken down by fund. Mr Earley is happy to meet with committee members to present this additional detail in confidence as is provided for in the legal commitments that we use to establish the funds, and bearing in mind our agreements on confidentiality relating to fund managers.

Finally we referred to the work of Professor Josh Learner. I attach the relevant quotes that Mr Earley referred to at the committee, a link to the publication that came from and the bibliography. We have also learnt that the ECF’s have been used as a case study by London Business School and Harvard Business School. The case study was discussed at an international conference on public support for venture capital which was held in November 2009 in Canada. Following the conference a formal case study is being prepared for students at Harvard Business School.

As I said in my concluding remarks to the Committee, the NAO report is balanced. It identifies areas for further improvement. It also acknowledges that the more recent schemes have learned lessons and are more likely to protect the taxpayer. BIS will continue to learn and apply lessons from the innovative and experimental programmes it has put in place since 2000. However, venture capital is, by its nature, high risk and the economic benefits and financial results only become apparent over time.

We intervene because there is a gap in the market and it is our view that the benefits this finance will deliver in terms of growth, jobs, innovation, R&D and exports will outweigh the costs of making the investment. We have begun to explore outcomes for the earlier schemes through the interim economic evaluations that have taken place, and will assess the final economic evaluation once each programme of funds has closed. The Committee wishes to review the performance in a few years and I will be happy to return and present our findings on the value for money of the interventions.

Simon Fraser
Permanent Secretary

1 February 2010

SUMMARY OF FUND PERFORMANCE AND BREAKDOWN OF FEES FOR EQUITY PROGRAMMES

		UKHTF	RVCF	EGF	BRIDGES	ECF	TOTALS
Size of Fund	Private	106.1	152.1	N/A	20.0	70.5	346.2
	Public	20.0	74.4	26.5	20.0	134.5	275.4
Commitment Drawn	Private	103.4	89.7	N/A	13.9	19.3	226.4
	Public	20.0	74.4	26.0	18.0	32.0	170.4
Fees*	Private	16.5	31.0	N/A	3.9	3.0	54.4
	Public	3.0	15.1	4.1	3.9	5.8	31.9
Sum invested		119.2	132.8	20.9	26.5	38.4	337.8
No of Investee Companies		245	356	136	29	45	811
Net Gains/Losses on Realisations		(2.0)	(15.2)	(5.1)	4.0	(1.3)	(19.5)
Total Fund Value (portfolio value plus net current assets)		60.5	93.3	14.9	23.7	41.8	234.2
Return of BIS as per Departmental Accounts (March 2009)**		0.0	6.0	17.8	11.3	30.6	65.7

* Fees calculated according to the nominal allocation between private and public investors

** BIS 2008–09 Annual Accounts—Valuations as per funds audited accounts plus drawdowns to 31 March 2009

THE FEE STRUCTURE FOR FUNDS ESTABLISHED AS LIMITED PARTNERSHIPS

Fees are controlled by the respective Limited Partnership Agreements but in all cases it is the Partnership (ie, not the investors individually) that is responsible for paying the fee to the manager. The level of fee is intended to cover the costs of the Manager with the Manager then incentivised to perform by a share in the profit of the funds once those profits reach an agreed level. For RVCFs this is usually when all investors, including HMG, have their investment returned and the private investors have a 10% IRR.

The Fee is paid (by the Partnership) as a first call on any income to the fund. This income could come from profitable exits or from investments that produce a yield. In the early years of any Partnership this income is not expected to be sufficient to cover the fee and so the Partnership is able to borrow (interest free) from the investors by drawing down part of their commitment. This loan is repaid as a priority before any profit is distributed. This mechanism allows for the funds to theoretically invest the total commitment without a reduction to cover costs.

The Partnership is owned by the investors so all are theoretically liable for fees. For RVCF and UKHTF the HMG money was drawn first as part of the agreed subordination but the loan for fee is still repaid to the Partnership as the first call on profits.

The above structure is known as a Priority Profit Share. Because of the structure fees are considered to be paid by the Partnership as a whole with no actual split between private and government investors. If there were to be a nominal split of fees paid between the partners however, that split would logically follow the proportionate share of the partnership attributable to each partner. In the case of RVCFs, this would mean that 32.8% of the total fees could now nominally be attributable to the tax payer.

This differs from the estimate of “around 25%” made by Mr Earley during the hearing. At the hearing Mr Earley gave a figure on the proportion of the fees which could nominally be attributed to the taxpayer which was an estimate prior to the RVCF programme launching. When the funds were established the public sector proportion of the total fund sizes was 29.7%, higher than the 25% initial expectation. However when it became evident that the funds would not invest all the monies available, Capital For Enterprise Limited renegotiated the contracts reducing the size of the funds to better align with what was likely to be invested. Because the public sector contributions to the funds had already been drawn down, these reductions impacted more on the private investors, hence the public sector now has a 32.8% interest in the funds and nominally pays that split of fees.

JOSH LERNER

Josh Lerner is the Jacob H Schiff Professor of Investment Banking at Harvard Business School, with a joint appointment in the Finance and the Entrepreneurial Management Units. Much of his research focuses on the structure and role of venture capital and private equity organizations. (This research is collected in *The Venture Capital Cycle*, MIT Press, 1999 and 2004, and *The Money of Invention*, Harvard Business School Press, 2001.)

Below are the quotes referred to by Mr Earley at the PAC Hearing:

“A second important lesson is the need for patience. Far too often, policymakers have expected immediate returns from their venture capital initiatives. The historical record teaches us that building a venture capital industry is likely to take many years. The “increasing returns” nature of the venture capital industry means that pioneering funds and entrepreneurs are likely to face many challenges. Impatiently abandoning a venture capital initiative after a few years because it does not seem to be yielding fruit is an all too frequent mistake of policymakers.”

“It is instructive to observe that all venture capital markets of which we are aware were initiated with government support. These markets do not appear to emerge without some form of assistance. This leads to the question as to what it is about these markets that requires the need for government support, at least in their formative stages.”

(Quotes taken from: *A study of New Zealand's venture capital market and implications for public policy* Lerner, Moore and Shepherd, 2005)

BIBLIOGRAPHY OF MOST RECENT BOOKS

The Boulevard of Broken Dreams: Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed—and What to Do About It. Princeton: Princeton University Press, Forthcoming.

Innovation and Its Discontents: How Our Broken Patent System is Endangering Innovation and Progress, and What To Do About It (with Adam Jaffe). Princeton: Princeton University Press, 2004.

The Money of Invention (with Paul Gompers). Boston: Harvard Business School Press, 2001.

Venture Capital and Private Equity: A Casebook. New York: John Wiley, 1999. New York: John Wiley and Sons, 2001 (second edition) (with Felda Hardyman). New York: John Wiley and Sons, 2004 (third edition) (with Felda Hardyman and Ann Leamon). New York: John Wiley & Sons, 2008 (fourth edition) (with Felda Hardyman and Ann Leamon).

Venture Capital and Private Equity: An Instructor's Manual. New York: John Wiley, 1999. New York: John Wiley and Sons, 2001 (second edition) (with Felda Hardyman and Ann Leamon). New York: John Wiley and Sons, 2004 (third edition) (with Felda Hardyman and Ann Leamon).

The Venture Capital Cycle (with Paul Gompers). Cambridge: MIT Press, 1999. Paperback edition, 2001.

The link below is a comprehensive bibliography of his publications on Venture Capital and Entrepreneurial Finance

<http://www.people.hbs.edu/jlerner/publications.html>.
