The Role of the Investor

Investors in venture capital have to accept that it is a long-term business in which they are prepared to have their money locked up for up to ten years in return for the expectation of substantial returns. In effect, the lock-up is less in a well-run firm because the money within a ten year fund is called down when needed over the initial three years and paid out to investors as distributions, when realisations are made, normally in the second half of the fund’s life.

The returns on individual venture capital investments with a specific company can be spectacular, which raises the profile of the fund and more than makes up for any disappointing investments. In terms of overall fund return, a leading investment bank issued an article, covering the period 1945 to 1993, in which venture capital emerged as the top performing asset class, with an IRR of 16.1% over the forty-eight year period. This figure certainly correlates with my experience over the last thirty years.

Venture capital investors can be individuals who are prepared to act as ‘angels’ in start-up companies often motivated by the tax breaks available to them. Or they can be individual or institutional investors, with large funds available, who are prepared to invest in a venture capital fund managed by a specialist firm. Such funds normally have a ten year life and involve a spread of investment in specific companies which gives diversification, within a defined policy, for the investor.

Corporate investors are playing an increasing role in venture capital, particularly in the US and Japan, and are usually looking for some commercial spin-off, such as the distribution rights to new products or an inside track as an acquirer, as and when companies in the portfolio come up for sale. It is important that these secondary motives do not adversely impact the fund’s
primary aim of optimising its return to investors, in these circumstances.

Governments are also taking an increased interest in venture capital but usually their involvements have strings attached, such as an obligation to help create local employment. Such aims, although admirable in themselves, are often counterproductive to the end which they seek to achieve, since they distort the commercial thrust of the fund and subject it, and its investee companies, to bureaucratic and restrictive rules and legislation.

Whatever the category of a venture capital investor, they must have a long-term view and should seek to be supportive of the companies or fund managers that they have chosen, provided that these entities behave properly and do not abuse their trust. Venture capital investors, who are fair-weather friends and short-term in their behaviour, can make the management of a fund very difficult, particularly where they have a large stake.

Good investors, and most of the people and institutions with whom I have worked are in that category, are a pleasure to deal with and are very reasonable, provided that they are properly communicated with and kept informed of any material problems. Whilst they do not like sudden bad surprises, they are normally very supportive of sensible solutions for dealing with problems.

Much of the money in UK private equity goes into the buy-out field because of the returns achieved in recent years in that sector. I believe, however, that institutions need to put more money into real venture capital, partly because the buy-out market is overcrowded and faces more difficult trading conditions and partly because the prospects for venture capital are very good. In particular, the healthcare and technology markets offer high growth prospects in an investment arena where growth is going to be increasingly difficult to come by.

With greater investor support to the venture capital sector, more young men and women of talent will be attracted into it and will be prepared to put in the groundwork of building-up their skills and experience in order to become effective in the sector. With time, it should be possible to develop a strong cadre of real venture capital companies in the UK, as has happened previously in the US.