

**Clarendon Fund Managers Limited
Response to the report of the
Independent Review of Economic Policy**

Clarendon Fund Managers Ltd
12 Cromac Place
Belfast
BT7 2JB
Tel: 028 90 32 6465
e-mail: info@clarendon-fm.co.uk

Clarendon Fund Managers Limited
Response to the report of the
Independent Review of Economic Policy

13 November 2009

Summary

We believe the Review Panel has put forward an interesting report in addressing its terms of reference and, in the midst of the severe but short-term economic crisis, Panel Members are to be congratulated for focussing on the assessment of existing strategies, policies and programmes and on other new approaches that seek to deliver sustainable and long term gains of productivity in Northern Ireland.

There is much with which to agree in the report, in particular the very first two recommendations that DETI dedicates more resource to policy development and utilises a permanent and independent economic adviser, since in devolving responsibility to Invest NI for initiatives directed to support for small businesses as part of regional economic regeneration, there appears to be a lack of clarity in where responsibility for policy-making and programme assessment lies between the Department and InvestNI. We suggest that the remit of this adviser be extended to assessment and comment on output of existing and any new initiatives of economic development including ante- and post analysis of value for money promised or delivered by such initiatives. Indeed, such in-depth probing of existing programmes and VFM analysis is sadly lacking from the report itself and we fully support the five recommendations made on page 11 of the report under the heading “Policy Performance”.

We understand the nature of the multifaceted problem facing all governments in increasing the prosperity and quality of life of its people and strongly endorse the report in Section 5.2 with its assertion that (in the absence of overwhelming indigenous mineral wealth) the only long term solution to achieving this goal is by building a high value added private sector economy. Indeed, it is from this belief that we concur with the report in asking for more focus in developing and assessing economic policy to sharpen the debate, and the subsequent action, in this area.

Nevertheless there are some areas where we believe the emphasis of the report does not reflect experience of operating in the sector. These areas are noted below and discussed in greater depth in the body of this response.

1. Venture capital and economic infrastructure (Sections 3.64 to 3.76)
2. Demand and supply of venture capital in Northern Ireland (Section 3.71 to 3.74)
3. Use of public sector finance (Section 3.76)
4. Disengagement of Invest NI from direct involvement with venture capital funds (Section 7: Overview of Recommendations – Finance)
5. Equity and debt financing (Section 7.15)

We believe strongly that the evidence associated with the above sections be re-examined and the accompanying recommendations be examined critically if Northern Ireland is to gain in productivity relative to the United Kingdom average and then to surpass this, since the UK, itself, continues to slip down the international productivity league table.

Finally, we would like to ask what happens next in this process of consultation; whether substantive policy and action is likely flow from any revised conclusions and the timescale thereof. The comments in this document are intended to be a constructive input to the on-going debate on regional economic development and we trust they will be construed as such.

Introduction

Clarendon Fund Managers Limited is an FSA-regulated, private venture capital fund management company that manages two funds in Northern Ireland, the Viridian Growth Fund LP (“VGF”) and the Nitech Growth Fund LP (“NGF”). The following background is provided to demonstrate the experience and knowledge derived from managing venture capital funds in Northern Ireland and from investing over the past nearly eight years in innovative businesses started and growing there. This background is supplemented by close, on-going experience, as participants in investment advisory and/or governance and oversight committees, of other UK venture capital funds.

One third (£3.34m) of the £10m VGF capital is subscribed by the public sector (DETI) – not the 50% noted in Box 3.1, page 66 of the Report – one third by private institutional investors and one third by the European Investment Bank. Invest NI has subscribed the whole of the £3m NGF capital (later enlarged to £3.6m), which started as an initiative of IRTU to stimulate commercialisation of research. NGF was conceived as a pilot exercise to understand the dynamics of investing in proof-of-concept projects and seed corn businesses and evolved into the £10m NISPO fund, with Invest NI providing 100% of the capital and, separately, the fees to manage the fund.

VGF has invested in £8.6m of its £10m capital over the period 2002 to 2008 into 20 companies of which 15 are in existence with 420 employees at 30 June 2009 (some 160 more than employment at the date of investment) and with a combined turnover of £33.4m as of the latest annual accounts¹. Investment into these companies, made over a number of financing rounds as the businesses develop and often led by VGF, has been over £54m. The investment focus of the fund has been early-stage, high-growth, knowledge-based businesses; all are competing in global markets, all have a high proportion of export sales, many (one exclusively) to the United States.

The structure of VGF has the return on the public sector investment subordinated to EIB and the private sector (so that these latter investors receive their initial capital and a compound annual rate of return (a hurdle rate) before returns commence to the public sector. The operational costs of the fund (audit, legal, compliance, governance, etc) and the cost of managing the fund are a charge on the capital of the fund and are required to be repaid to the fund from capital appreciations and/or income before the hurdle rate applies. Having received £10m from investors (including DETI) the fund has to return £10m to investors, net of all costs of operating and managing the fund, together with the annual hurdle rate of return from the fund inception.

NGF, noted in the IREP report in Sections 4.38 and 4.39, has invested £2.9m in 16 companies as part of funding rounds totalling £16m, predominantly led and structured by CFM.

¹ Turnover and leverage numbers noted above exclude the values for ARTG Inc, a Nasdaq quoted company (turnover now ca \$170m) which early-on acquired a portfolio company in a share exchange and from which the fund has now exited with an 11% compound annual growth over the seven years of its investment.

Importance of Venture Capital to Economic Regeneration

The report notes once, and almost in passing (Section 3.66 and footnote), the “significant body of evidence” for the economy in general of company access to private equity. Apart from the possible confusion between the whole field of private equity and the more specific provision of venture capital, perpetuated in Figure 3.8 of the report, this passing reference does not do justice to the knowledge, generated by many and enduring practical examples, of the fundamental importance venture capital, rather than the broader private equity, continues to play in financing innovative small companies and thereby in regional economic development. Indeed, instead of asking why this is not the case for Northern Ireland, this “body of evidence” is ignored in the following sections and the fallacies that the Varney Review sustained.

This broad consensus of opinion, shared amongst others by the USA, the European Commission² and the United Kingdom Government, that venture capital directed at the small enterprise sector is of high importance, arises from the deeper understanding in current economic theory of the importance of technology innovation. The preferential adoption of innovation within SMEs is seen as the critical determinant of sustained economic growth and job creation, with evidence that a continuing supply constraint in risk capital for SMEs is holding back realisation of these economic benefits³.

Venture capital is a necessary component of SME growth, and part of a wider network of “shared knowledge and specialist support services”⁴ for the financial and SME sector; indeed the venture capital supply constraint has been attributed to a lack of these network economies. The slow development of these network economies explains, in part and alongside the need to produce educational and cultural changes in the regional population, why increasing the rate of innovation and building the level of entrepreneurship in a region is a long term task. Examples given at the US-Ireland Business Summit⁵ by Molly Corbett Broad, then President of the University of North Carolina, of the 40-year history of development of the N Carolina Biotechnology Triangle and by Governor John Engler in developing an international cluster of innovation in development and commercialisation of alternative energies which, with other economic policies, has created more than 800,000 new jobs in Michigan over the preceding 12 years, demonstrate the positive results of the need for this long term view.

² EU Amsterdam Summit June 1997; Lisbon Council Meeting March 2000; European Economy Supplement A (Economic Trends) No 8/9 August/September 2000.

³ Bannock Consulting Final Report: “Innovative Instruments for Raising Equity for SMEs in Europe” Study Contract ETD/00/503116; Report to the US Senate Committee on Small Business “Small Business: Efforts to Facilitate Equity Capital Formation” GAO GGD-00-190 September 2000.

⁴ See Bannock above

⁵ Washington DC September 4-6, 2002

Demand and supply of venture capital in Northern Ireland

It is difficult to establish the balance between supply of equity finance and demand, especially in a juvenile and isolated market such as Northern Ireland, since the market is dynamic, subject to endogenous perturbations and always growing. Demand in Northern Ireland is depressed for many reasons, in part because historically private sector venture capital has to compete with grant finance from Invest NI, in part from the lack of the network economies noted above which take long term and sustained development and, in part, through lack of availability of venture capital to stimulate demand.

The lack of provision of early growth finance for companies in the United Kingdom has been long-known (long pre-dating the formation of Investors in Industry, later renamed 3i, established to address this so-called “funding gap”) and, in the context of the long timescales of innovation and regional economic regeneration, measures to address the problem have proved temporary – the re-named 3i for example, on evolution into a publicly-quoted company has migrated into provision of finance for large international MBOs and announced it has withdrawn from investing in the technology sector. Successive United Kingdom Governments have, with European Commission blessing, continued to introduce measures of support with increasing size across England, Wales and Scotland to stimulate private sector equity investment (or as a minimum, equity investment under private sector commercial management and terms) into this sector of the economy. These measures have been broadly successful, despite the learning curve exhibited by those venture capital fund managers involved with the early equity funds, in finding investment demand. One can only ask why the conditions in Northern Ireland are such that provision of funds is thought not to have the same capability of creating demand for investment.

Currently there is greater demand in Northern Ireland than there is indigenous supply. The lack of provision of finance is especially acute for young innovative, knowledge-based companies (and almost terminal for biotechnology-based businesses), which often require large investment and long timescales before they become self-financing or able to access mainstream commercial financing sources, and which in general are not able to attract investment from outwith the region. The problem is exacerbated as (in relative terms) short term perturbations in the funding climate caused by problems in other sectors of the world economy translate into even greater private sector aversion from investing in this sector. The reason for seeking and supporting these companies is the enormous return and the disproportionate contribution the few that succeed make to long-term employment growth.

At present the region has a Proof of Concept and a seed corn fund (NISPO) at a very early stage of the fund life and with little of the allocated £10m public sector financing of the fund committed to SMEs. The next stage of investment was inhabited by the subordinated public-private partnership, the Viridian Growth Fund, behaving as a much larger fund through very significant amounts of syndication but now fully invested and unable to make further investment. Crescent Capital II follows in ascending order of investment stage and size, but with a limited life before it too has to reserve investment for follow-on into its existing portfolio.

The funding chain at present is therefore adequately supplied at the lower end (but support is likely to continue to be required and provision should be made in 2013 or earlier for the proof of concept fund if it, and the investment readiness programme, starts to produce adequate investor-ready businesses). The chain is already deficient at the early development capital

stage, with few investments being made in this sector throughout the Province with VGF now fully invested. The third part of the chain, funds for investment into continued development of well-established companies, will be needed as Crescent II becomes totally invested and Enterprise Equity focus more on the more mature development opportunities, and the MBO space historically serviced by the banking sector. This space is well inhabited within Great Britain by regional funds, by midrange funds able to invest nationally (typified by Enterprise Capital Funds) and, to an extent, by larger international funds, the latter two types both willing to take a train from London to Oxford, or even further, but generally unprepared to travel to Northern Ireland. One or more funds creating investment rounds of £2m to £8m and capable of investing £2m to £3m themselves should produce a deal flow to tempt private equity funds not already on the island, to visit on a regular basis and to invest.

In conclusion to this section, and as managers of venture capital funds for investment in the Province, we believe both Varney and the present review of venture capital demand reached fundamentally wrong conclusions. There is evidence that supply stimulates demand, and we have shown how £3.34m of public funding has leveraged over £50m of other investment for innovative technology companies, many of which would have been unable to commence operations or, at best would have grown more slowly without the finance, guidance and help provided through the venture capital approach. With a £10m Viridian Growth Fund there was a limit to the number of companies in which one can afford to invest, given the experience that the high growth portfolio companies would individually require many millions of pounds to reach the stage where they could attract mainstream financing and consequently funding had to be rationed to ensure co-investment in later stage funding rounds.

In addition, we note the comment from Varney quoted in 3.73 (a view by that time heavily dated given the preponderance of public sector funding of access to capital schemes and the known aversion of the private sector to support young technology companies) and submit that it is the historical grant culture, lack of maturity in the commercial infrastructure and low choice and complete range of locally focused Funds (which are much more prevalent, varied and mature in other regions of the UK and Ireland, as a result of sustained long term public sector support) that has inhibited growth of young technology companies.

Use of public sector finance

The report “suggests a role for Government in supporting the provision of equity finance in seed stage projects” (Section 3.76). It is unclear from the concluding part of Section 3.76 whether the recommendation of the report is that support for venture capital in later (development) stages of investment is unnecessary or that it is necessary but that policy development and action taken between DETI and Invest NI has been inadequate. These intertwined issues are discussed below.

Deficiencies in the provision of finance for innovative technology growth companies are well recognised and continue to be addressed throughout Europe and, in the United Kingdom, by provision of financial support from ERDF, EIB, EIF and Member States for venture capital funds and by National and regional policies which tie this provision of access to capital into National and, especially, regional economic development strategy.

Categorically, it is vital that public sector support is continued within Northern Ireland, as it continues to be supported throughout Great Britain, if the fledgling venture capital industry is to become firmly established and able to provide the strong commercial input that private sector fund management should supply. The alternative is to use the existing grant system which does not necessarily require recipients to conform to market and commercial forces and does not

prepare grant-aided companies to compete in the free market, whether that of raising finance or of competing globally for market share.

The public sector intervention should extend beyond provision of proof of concept and seed corn financing of funds and be extended to later stage funding of innovative technology companies through appropriate public-private partnership funds. The oft-mentioned “funding gap” of £250k, the same absolute value as established when Investors in Industry (later renamed 3i) was started⁶, is still often quoted as relevant, when the true financing requirement is at least ten-fold for the gazelles⁷ that the UK needs to foster and higher still for that five percent of such companies that are high tech, innovative, mostly young firms with enormous growth potential. The reason for seeking and supporting these “super-gazelles” is the enormous return and the disproportionate contribution the few that succeed make to long-term employment growth⁸.

The rationale for public sector intervention is not-necessarily the oft quoted “market failure” of the private sector to invest in these businesses. The private sector has the strong perception, fuelled by the sector statistics of the BVCA and other trade bodies, that the returns on early stage investment are not commensurate with the risk (bluntly, higher returns can be made with less risk by investing in later stage businesses which have experienced management teams, products, market presence and sales, than in early stage businesses). This is not market failure, but the market behaving rationally – albeit with a herd instinct which sees the prices for later-stage deals and MBOs driven higher by competition between private equity financiers and the use of (as has been proved) excessive levels of debt provided by unknowing bankers in order to leverage the returns for the financiers’ benefit. This latter phenomenon is in the process of correction; the underlying economic facts remain.

Market failure arises for two reasons. First, the private sector does not, nor necessarily should, factor into its (relatively short-term) returns the broader economic, social, cultural and even political returns to society, the State and the region from assisting the survival and growth of early stage and technology-based companies. These returns include increased employment opportunity and retention of highly skilled and educated workers, increase in demand for local professional services, enhancement of such “quality of life” markers such as the cultural and educational base of the region, not forgetting enhancement of the local tax and an increased rate base.

The second reason for market failure arises because the market is inefficient in that the relatively few investors in this sector cannot easily obtain adequate information about the pool of companies offering investment opportunity – a phenomenon in the recent BVCA/Nesta report called a “thin market”. These markets are characterised by requiring an extended period of time to build investor confidence and venture capital investment expertise, together forming part of the network economies noted above.

To re-iterate, public sector intervention has been widely accepted in the developed and developing world as a tried and tested approach in assisting regional economic growth. The market failure and similar arguments made previously need little or perhaps no further justification - as witness the continued and recent sanction by the European Commission of a

⁶ In 1945 with £15m capital “to provide capital for growing independent businesses....”

⁷ Gazelles: the name used by The European Observatory for SMEs (6th edition) to describe firms that have been growing at 20% or more a year for four years, and which have an appetite for risk finance.

⁸ Oxford Instruments plc, originally invested in by 3i in 1987, is just outside the gazelle definition with growth of 16% pa over the past 4 years, though it had a turnover of £206m and over 1,500 employees in its latest (2009) financial year

variety of venture capital funds within the United Kingdom, excluding Northern Ireland, incorporating public sector support.

The characteristics of the recent UK regional funds are that they:

are conceived as public-private sector partnerships under FSA-approved private commercial fund management;

provide a range of options for private sector involvement, from investors in limited partnerships to effecting private sector investment match at point of investment;

offer a range of funds from proof of concept (not necessarily requiring private sector co-investment) through early and later stage equity and mezzanine loan provision – the latter of doubtful utility for technology-based growth companies requiring a number of equity investment rounds);

seek to provide a continuum or ladder of finance provision for early to later stage businesses;

create provision for re-cycling of return of the public sector investment into legacy funds often under the stewardship of a separate non-profit company limited by guarantee⁹ to continue investment, or to provide venture capital demonstration projects, where the private sector is disinclined to act; and

provide pump-priming access to capital on sufficient scale to produce notable regional impact.

In conclusion to this section:

there is a necessity that public sector financing of venture capital activity be continued, rather than the role suggested by 3.76, and this provision should be accompanied by curtailment of grant finance;

we do not accept that public sector intervention in venture capital funds should be restricted to the seed corn sector, but should be extended to enable commercially managed funds to be brought together that would not otherwise be able to attract private sector financing and on a sufficient scale to finance innovative technology companies from cradle to sustainability of financing from wholly-private sector and commercial sources; and

For clarity, DETI should accept responsibility for recommending policy and operating strategy in the area of provision of access to capital, with Invest NI accepting responsibility for policy implementation and for monitoring performance of the resultant funds.

⁹ Merseyside Special Investment Fund, more recently NStar Finance Ltd (N East of England) and, as early as 1986, a Greater Manchester ERDF regional fund, all provided for public sector returns to create legacy funds for continued investment.

Disengagement of Invest NI from direct involvement with venture capital funds

We have already noted that public sector support is required to stimulate private sector co-investment in young innovative technology companies and will not re-iterate our comments. However, we are unsure of the premise upon which the recommendation (Section 7.25) that Invest NI should disengage from direct involvement with venture capital funds is based. What, in fact, is the organisation's present involvement other than providing finance from a centrally-provided budget to a fund manager appointed under a public procurement contract?

Nor do we understand what is meant by Invest NI acting as a facilitator between companies and venture capitalists. The interaction of any venture deal is directly between the two parties, the company requiring, and the venture capitalist supplying, financing. Is a facilitator an introducer, or a source of suggestions of deal terms, an advertiser for the funds in their search for deal flow?

We accept that Invest NI personnel should neither be involved in investment decision-making within a public sector-backed fund, nor involved with its management. If not handled within the Department, Invest NI may well be the vehicle through which DETI implements its policies of access to capital, the vehicle through which financing is channelled to the desired funds, the organisation responsible for the fund management selection processes and the body monitoring agreed outputs. But what does suggested facilitation involve, other than a duplication of activity better and more appropriately carried out by the private sector by corporate finance advisors, corporate lawyers, accountants and industry bodies?

Equity and debt financing

We believe the recommendation that Invest NI financial intervention in companies not involved with innovation or R&D be made in the form of debt or equity falls into the category of the interventions noted by Varney as having "unintended consequences" (Section 3.73) of crowding out private sector commercial investors. Why intervene, other than in the situation of seeking to attract inward investment, and would the region wish to attract this type of non-innovatory inward investment? We agree that grants should be phased out before we are forced to stop them but that this cannot be allowed to create a vacuum of funding and financing of indigenous businesses should be aggressively expanded from private sector sources or via public sector supported, privately managed venture capital funds. Finance for well-established innovative firms, if falling outwith the remit of funds established for SME investment, should be via equity.

Conclusion

As noted, we agree with much of the IREP report. We would like to see greater clarity in measuring performance and value for money of programmes for encouragement of innovation and business support. We have strong beliefs that innovative technology businesses fuel economic regeneration, that a funding hole for innovative technology businesses already exists within the region, that venture capital is the strongest component of the mix of skills and facilities required to fund these businesses and that strong public sector intervention is needed to grow the embryonic and now declining venture capital industry in the region.

We hope this document is viewed as it was intended, namely as a constructive response from an organisation dedicated to the economic well being of Northern Ireland. We are prepared to offer further explanation on the points rehearsed above if required.

Clarendon Fund Managers Ltd