Evaluation of the Scottish Co-Investment Fund (April 2009 – December 2013)

FINAL REPORT TO

Scottish Enterprise

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A EXECUTIVE SUMMARY

EVALUATION PURPOSE, SCOPE AND PROCESS

This evaluation of the Scottish Co-Investment Fund (SCF) was commissioned by Scottish Enterprise and conducted by Malcolm Watson Consulting (MWC) between December 2014 and March 2015 covering investment through SCF in the period between 1st April 2009 and 31st December 2013. Investments over this period are referred to as being made through SCFII.

The SCF is funded by the Scottish Investment Bank (SIB) with support from the European Regional Development Fund and provides equity funding to eligible businesses. SIB investment through SCF is made on a *pari passu* basis with one or more of 29 accredited private sector investment partners. The SCF can contribute from £100,000 to £1m on a £ for £ basis in investments with Partners with a total value of up to £2m and with the SIB contribution not exceeding 50% of the deal value.

The overall purpose of the evaluation was to assess the extent to which the SCF had influenced the early stage risk capital market in Scotland and to demonstrate the effects investment through the Fund has had on the invested businesses.

The primary evaluation research comprised analysis of fund performance data, consultations with stakeholders and investment partners and a survey and associated in-depth analysis of the performance of a sample of 49 SCF-invested businesses.

EVALUATION CONCLUSIONS

The evaluation conclusions are reported in full in Section 10 of the Report along with references to specific sections in the report with findings which support the conclusion. The main conclusions from the evaluation are summarised below.

SCFII RATIONALE

The rationale for intervention through SCFII remains valid. Securing of equity finance for young pre-revenue businesses in Scotland remains challenging evidenced by the conclusions of our business survey. All investors interviewed considered the SCF to be addressing a valid ongoing and structural market failure in the supply of risk capital for start-up and early stage businesses. There is a strong public policy rationale for intervention in providing equity investment for young, potentially high growth and innovative pre-revenue businesses. Angel Syndicates, and matching SCF, represent a significant proportion (35%) of the total private equity investment in small businesses within Scotland.

SCFII FUND PERFORMANCE

Given that SCFII investments were anticipated to be exiting, on average, 7 years after investment, (i.e. in the period 2016 to 2020), it is **too early to draw substantive conclusions on performance of the Fund**. This is compounded by evidence from investor consultations suggesting that exits are taking longer to achieve than anticipated with expectations that these may take over 10 years.

Over the evaluation period the **SCFII has invested £45.5m in a total of 139 Businesses** and levered **private sector SCFII Partner investment of £74.6m** - a private to public sector leverage ratio of 1.64:1. Year-on-year, over the evaluation period, increasing proportions of total fund investment have been taken up by follow-on deals. In 2009 SCFII follow-on deals represented 11% of total SCFII investment to the end of that year with this proportion rising to just over 40% of total SCFII investment to the end of 2013.

Partners report that their experience of failures amongst SCFII investments is within their expectations from other (non SCFII funded) investments and some are bullish about the prospects for good returns.

Analysis of SIB portfolio data shows that the proportion of SCFII investment written off is running at a rate of 4.2% of SIB investment through the Fund to the end of FY 2013. Income received over the same period is equivalent to 7.7% of SIB investment made through SCF to the end of FY 2012/13.

SCFII IMPACT ON SCOTTISH RISK CAPITAL MARKET

Overall, we conclude that, over the evaluation period, **SCFII has represented a significant proportion of the risk capital market in Scotland in the sub £2m deal space**.

Investment in the SCFII deal-space (£100k to £2m) in Scotland in 2012 and 2013 is estimated at £82.5m. Of this £39.5m **SIB investment through SCFII accounted for £14.2m or 17% of the total estimated value of the SCFII deal-space market between 2012 and 2013**.

Partners report SCF has **increased the number of deals** they completed in Scotland. SCF has also resulted in **some deals being larger** than would otherwise have been the case, providing resources to make a step change or extending the period to next funding round.

SCFII DELIVERY

Our consultations with 49 SCFII-invested businesses, 13 SCFII Investment Partners and Stakeholders confirmed that, the **Fund delivery arrangements have worked satisfactorily** for all of the parties with some noted exceptions in individual cases.

COMPLEMENTARITY OF SCFII INVESTMENT

Whilst SCFII investment *per se* is an important contributor to the growth of the invested business (and often cited by businesses as the most important), **it is the combination of investment and support to the businesses' SMTs provided by the SCF Partners, SE Account Managers, SIB Portfolio Managers (and the NXDs and other advisors identified by them), that together provide the best conditions for optimal growth and success**.

The responses we received from our business survey confirmed that SCFII and other assistance received from SE and SIB are complementary and that many businesses would not have developed as they have without the range of support (including SCFII) they have received. It was also clear that, dependent on the particular circumstances of each business (including the skills of their management team and their access to other advisors) and their specific requirements for capital investment at key stages in their growth, SCFII has been a fundamental requirement for their development.

SCFII IMPACT ON INVESTED BUSINESSES

In our consultations with the 49 SCFII-invested businesses and 13 SCFII Investment Partners we explored the impact the SCFII investment has had on the businesses.

The SCFII investment received by the businesses we consulted has been instrumental in sustaining and progressing their growth. It has done this primarily by providing equity finance to those businesses at points where they would not secure debt or VC funding because of their risk profile, time to revenue generation and scale of finance required. 87% of Business consultees reported that their SCIIF investment had a positive effect on their business – by either ensuring survival, preventing contraction or stagnation or allowing them to grow more quickly. **Businesses in our sample associated actual and projected turnover of £1,840Mn with their SCFII investment**.

ECONOMIC IMPACT OF SCFII

Overall, we conclude that, **SCFII has the potential to generate significant economic impact at the Scottish and UK levels**. This is based on the identification, amongst our sample of:

- **High levels of additionality** based on consequences for the businesses of not receiving SCFII investment at the time they did.
- **Minimal displacement** due to low levels of domestic competition and strong growth in target markets.
- Strong actual and projected **export performance**.

To date (2015) SCFII invested businesses in our sample are estimated as having generated £31.4Mn of Net Additional GVA (NAGVA) from SIB and Partner Investment, Projected **NAGVA to 2025 is estimated on this same basis at £290Mn**.

Value for Money ratios for the sample investment value of £21.3m (SIB only including an estimate of staff costs over the evaluation period) are: **1.5:1 in 2015 rising to 13.6:1 in 2025**. These ratios use the assessed NAGVA from combined SIB & Partner SCFII investments and the cost of SIB investment only – as specified by SE Appraisal and Evaluation. These ratios are based on at risk SIB investment values and will underestimate VFM because they assume that no funds will be returned to SIB or on exits from SCFII investment. However, any such underestimate will be compensated for to some extent by the additional costs to SE and SIB of supporting these companies through other interventions that have not been factored into the evaluation.

This assessment has allowed for pro-rata apportionment of benefit to other SIB investment in these businesses but has not been adjusted to reflect the other important, but less readily quantifiable assistance to them from SE (including Account Management), which has contributed to benefits generation.

Net Additional employment in the sample businesses is estimated at 240 FTEs in 2015, rising to a **peak of 660 FTEs based on projections to 2025**.

RECOMMENDATIONS

Based on our evaluation research and conclusions we provide the following recommendations on the SCF.

- The SCF should continue to operate as a Partner-led Co-investment investment fund on the MEIP addressing structural issues in the equity (risk) capital market in Scotland.

- SCF investment should continue to be delivered in a context where co-ordinated support, advice and potential future investment from SCF Partners, SIB and SE is understood to be not only complementary but essential to optimising the growth of the SCF-invested businesses.

- The Partners and SIB need to continue to work to accelerate and secure successful exits and to take appropriate action where exits appear unlikely. Where exits are achieved which generate a surplus or wholly or partially return invested funds, they have the potential to enhance the value for money delivered by SCFII. This is because VFM calculations presented in this evaluation assume no return of SCFII invested funds.

- SCF depends on successful operation of angel syndicates and the continued support those angels receive from national (UK) tax incentive schemes – most notably SEIS and EIS. All those engaged in the market for early stage risk capital need to acknowledge and promote the role of the business angel.

- SIB needs strong, professional and well administered angel syndicates to operate the SCF as a market-led Fund. This will continue to require careful selection and selective development of syndicates to ensure SIB can maintain a pari-passu approach to investment, giving the market its place in appraising and selecting investments and optimising the costs of engagement for the public sector. To date LINC Scotland has played an important role in developing and providing ongoing support to emerging syndicates. It may also have a role, going forward, in continuing to develop syndicates.

- There is a case for increasing the ceiling for the SCFII contribution and deal size, given both the passage of time since these were last reviewed in 2007 and the observed migration of VC investors to higher deal sizes.

- There are innovations in the market within which SCFII operates including Crowd-funding and hybrid models including both crowdfunding and angel syndicates. SIB and its partners need to be alive to these innovations and explore ways in which they can be used alongside SCFII to optimise the availability of equity funding for young innovative businesses which add value to the Scottish economy.

1. INTRODUCTION

1.1. General

This document reports the process, conduct, findings and recommendations from an evaluation of the Scottish Co-Investment Fund (SCF).

The evaluation was commissioned by Scottish Enterprise and conducted by Malcolm Watson Consulting (MWC) between December 2014 and March 2015 covering investment through the SCF in the period between 1st April 2009 and 31st December 2013.

The evaluation covers all aspects of the operation and performance of the SCF over this period and also assesses the progress of the SCF in delivering against the objectives and projected outcomes set out in a 2008 application for ERDF assistance to its delivery. In the remainder of this report we use the following terminology to refer to the Fund:

- SCF is the generic term for the Scottish Co-Investment Fund and is used when describing aspects of the Fund which have pertained from its establishment through to the date of this report.
- SCFII refers to the Fund and associated investments made in the period between January 2009 and the date of this report. SCFII is programmed to close in December 2015.
- SCFI refers to the Fund and associated investments made in the period between the establishment of SCF in March 2003 and commencement of SCFII in January 2009.

1.2. The Scottish Co-Investment Fund

The SCF is funded by the Scottish Investment Bank (SIB) with support from the European Regional Development Fund and provides equity funding to eligible businesses[1] on a *pari passu* basis with one or more of the 29 accredited private sector investment partners. The SCF can contribute from £100,000 to £1m on a £ for £ basis in investments with Partners with a total value of up to £2m and with the SIB contribution not exceeding 50% of the deal value.

1.3. Evaluation Purpose and Process

The overall purpose of the evaluation was to assess the extent to which the SCF had influenced the early stage risk capital market in Scotland and to demonstrate the effects investment through the Fund has had on the invested businesses.

This has been addressed through research consisting of:

[1] SCF-eligible investment prospects need to be SMEs with an existing or planned presence in Scotland proportionate to investment sought. There are also potential restrictions on investment in certain activities. The SCF eligibility criteria are reproduced at Appendix 1.

- A review of information and data on the Fund and its investment activity and performance over the evaluation period.

- Review of the evaluation of SCFI undertaken in 2008[2].

- Consultations with Stakeholders, SCF Investment Partners, SCF invested businesses and SIB and SE executives.

- Review and analysis of data and opinion on the market for early stage equity finance for Scottish SMEs.

- In-depth analysis of the actual and projected performance of the invested businesses over the period since their SCFII investment.

1.4. Evaluation Report Structure

The remainder of this report is structured as follows:

- **Section 2** sets out the Evaluation objectives and method.

- **Section 3** traces the evolution of the SCF, from original rationale through to current operation.

- **Section 4** considers the current state of the equity funding market in and around the SCFII deal size range.

- **Section 5** provides an analysis of the investment activity and performance of the SCFII investments in the period between April 2009 and December 2013.

- **Section 6** summarises the findings of our primary research amongst the SCFII investing Partners.

- **Section 7** summarises the findings of our primary research amongst the SCFII invested businesses.

- **Section 8** provides our assessment of the economic impact to date and the potential future impact from SCFII investments made between April 2009 and December 2013.

- **Section 9** assesses the performance of the SCFII against the objectives and outcomes contained in the 2008 application for ERDF assistance to SCFII.

- **Section 10** presents our conclusions on the operation of the SCFII over the evaluation period, the continuing rationale for public sector intervention in the equity funding market through the SCF and recommendations for any future operation of the Fund.

[2] Evaluation of the Scottish Co-Investment Fund. 2008. Hayton Consulting & GEN.

2. EVALUATION OBJECTIVES AND METHOD

2.1. Introduction

In this section of the report we outline the objectives of the evaluation as set out in the brief to the Consultants and summarise the evaluation method used to deliver against these objectives.

2.2. Evaluation Objectives

The overall evaluation goals, as stated in the evaluation brief, were to

"assess the impact that support through SCF has had upon the growth of the investee companies and the extent to which SCF funding and support complements other support provided through SE".

The evaluation was required to assess:

" *'what works' in terms of addressing market failures and gaps*." and

"the extent to which the SCF delivery arrangements have influenced the early stage risk capital market in Scotland, improved access to funding and what, in turn, this has meant for the performance of companies who have secured this funding."

The evaluation was also required to assess:

- The extent to which the original rationale for SCF is still valid and, if this is no longer the case, to explain why and how this rationale has changed.
- The commercial performance of the Fund based on the number of investments to date, their value, losses and exits.
- The impact of SCF on the capital market in Scotland including the impact on the co-investees.
- The effectiveness of the SCF delivery arrangements, including the role of the SCF partners and evidence of value added, post investment management arrangements, and areas for enhancement.

2.3. Other Assistance to SCF-Invested Businesses

Many of the SCFII-invested businesses have been the beneficiaries of other business development and support resources from SE (mainly through the Account Management system, with 71% of investees being Account Managed at one time (see 8.6)), SIB and other providers. Of the 139 population, details of the additional support given to 65 that were currently Account Managed were available. These companies had received £23.5 million through SCFII between 2008 and 2015. In addition, they had received:-

- A further £13 million through other SIB investment funds:
- £4.3 million through SMART;

- £2.7 million in RSA grants; and
- Support through the Intervention Frameworks, in particular for Market Development, Innovation, Strategy and Business Improvement.

The evaluation was specified to provide for the dilution of SCFII investment effects by other *SIB investment* in the businesses over the evaluation period. However, the dilution effects from other assistance have not been quantified, and it is important to recognise that SCFII benefits have in part been facilitated by this other support and assistance.

2.4. Evaluation Method

The method included secondary research and analysis of market and Fund data alongside primary research amongst Fund Stakeholders, SCFII investment Partners and SCFII invested businesses. In summary, the method comprised:

- An inception meeting where the Method was reviewed, initial data and information was exchanged and initial drafts of research materials reviewed.

- Ongoing liaison with, and provision of information, clarification and guidance by SIB and SE Appraisal and Evaluation executives over the course of the evaluation process.

- Review of Fund investment data for 140 SCFII-invested businesses extracted by SIB from their Investment Management Reporting System (IMRS) database.

- Review of current market data and research on early stage and growth business finance at both UK and Scottish levels.

- Selection by the Consultants of a sample frame of 66 businesses which were representative of the population of 140 invested businesses over the evaluation period. On reviewing the data it was apparent that there was a concentration of investments in two SE growth sectors – Enabling Technologies (ET) and Life Sciences (LS). It was elected to adopt a census approach to invested businesses in other sectors and for the Consultants to randomly select interviewee companies from the ET and LS sectors. This random sampling was conducted by MWC before reviewing results for outliers. This proposed sample was subject to two substitutions by the Consultants where the previously selected businesses were incapable of responding due to inactivity (1) and insolvency (1).

- Conduct of primary research using face-to-face and telephone methods amongst 50 invested businesses (selected from the sample frame) which agreed to engage in consultation.

- Conduct, face-to-face, of primary research amongst 13 Investment Partners from a frame of 16 identified by SIB as having significant and relevant experience as an active Partner in SCFII.

- Conduct of face-to-face consultations with stakeholders in Scottish Government, Scottish Enterprise, Highlands and Islands Enterprise, SIB and LINC Scotland.

- Presentation and facilitated discussion of emerging findings with the Evaluation Steering Group and at two workshops - one convened with SE Account Managers and the other with SIB Portfolio Managers.

- Synthesis and analysis of the research findings into draft and final reports and an accompanying Economic Impact Assessment Model.

In conducting our evaluation we were greatly assisted by the SCFII Partners and invested businesses who made themselves available for consultation. They provided invaluable feedback and opinions on the operation of the Fund and its effects on the performance of their businesses and investments. Throughout the evaluation we also received input and support from staff in SE and SIB, providing data on fund performance, invested businesses and guidance on evaluation process in SE. We are also grateful to SIB Portfolio Managers and SE Account Managers who provided feedback on initial findings and perspective on the important interactions between SIB investment and other SE support to the development of the invested businesses.

3. EVOLUTION OF THE SCOTTISH CO-INVESTMENT FUND

3.1. Current Format

At the time of commissioning this evaluation the SCF provided equity funding to eligible businesses[3] on a *pari passu* basis with one or more of 29 private sector investment partners. The SCF can contribute from £100,000 to £1m on a £ for £ basis in investments with Partners with a total value of up to £2m and with the SIB contribution not exceeding 50% of the deal value.

The SCF is one of a suite of investment instruments used by SIB to facilitate investment in businesses based in Scotland. **Table 1.1** places the SCF in the context of other SIB activity as it existed when the evaluation was commissioned.

Table 1.1 SIB Equity Investment Product Range

	SIB Minimum	SIB Maximum	SIB Max % of Deal	MAX Deal Size	Type
Scottish Seed Fund (SSF)	£20,000	£250,000	50%	None	Equity
Scottish Co-Investment Fund (SCF)	£100,000	£1,000,000	50%	£ 2,000,000	Equity
Scottish Venture Fund (SVF)	£500,000	£2,000,000	50%	£10,000,000	Equity

The SCF parameters place it in the £200,000 to £2m equity deal-space where it can provide for businesses progressing from previous funding through SSF or, as can be the case, in advance of SIB portfolio investment through the Scottish Venture Fund (although there is no requirement for or presumption of progression through SIB Funds). The Scottish Portfolio Fund (SPF) is also available to provide follow on investment into SIB Portfolio companies where there is requirement and cannot be fulfilled within the other fund parameters.

3.2. Establishment and Evolution to 2008

The evolution of the SCF is illustrated in the timeline in **Figure 3.1** (overleaf).

The Scottish Enterprise Board first approved the SCF in November 2002, with the first SCF Investment Partner Partnership agreements signed on 31 March 2003. This is referred to in the remainder of this report as SCFI.

At the point of application for ERDF in Autumn 2003, a total of 13 Partnership Agreements had been signed, and 8 investments valued at £1.2m had been made by these Partners leveraging £4m of funding[4].

[3] SCF-eligible investment prospects need to be SMEs with an existing or planned presence in Scotland proportionate to investment sought. There are also potential restrictions on investment in certain activities. The SCF eligibility criteria are reproduced at Appendix 1.
[4] SE Board Paper SE (03)155

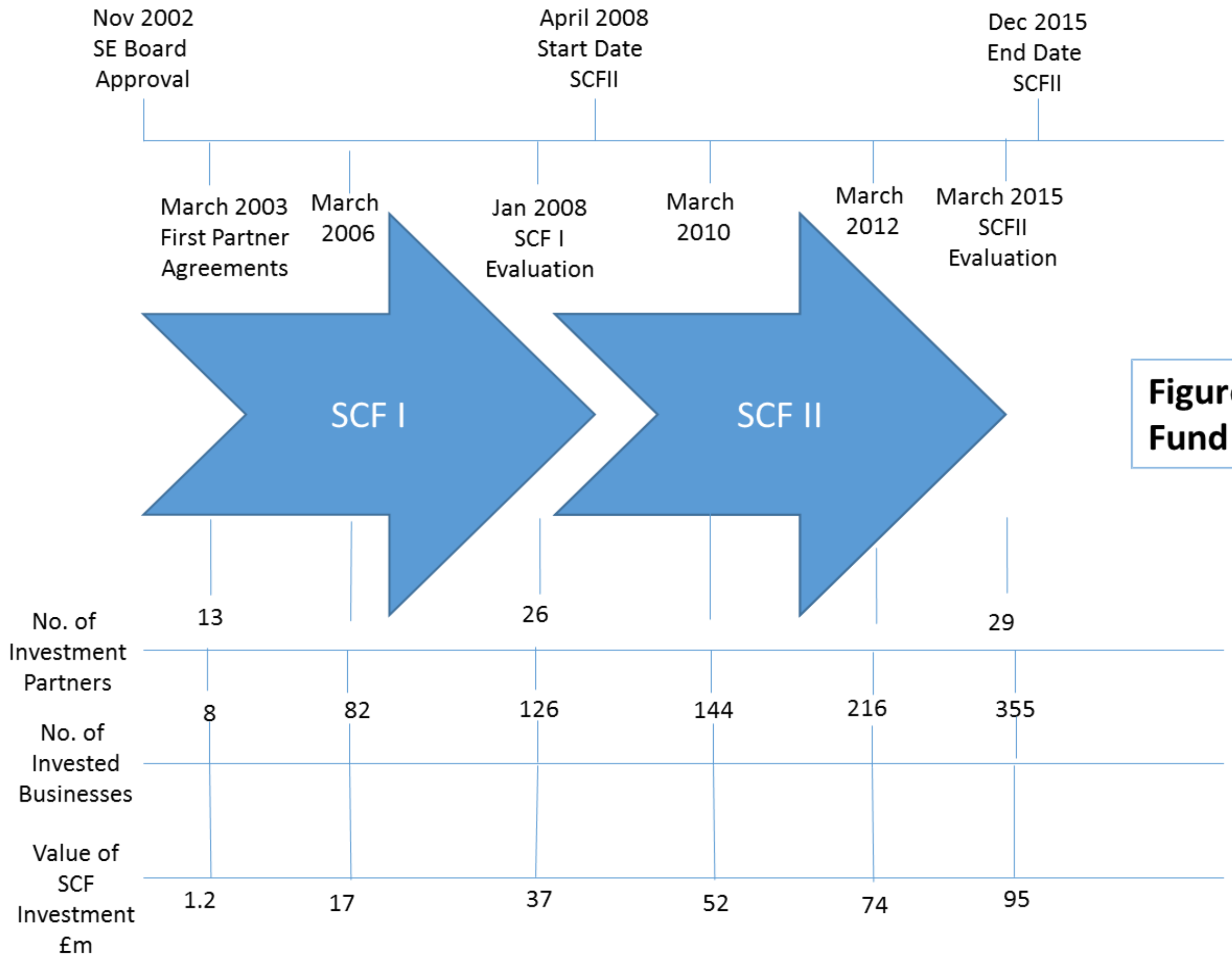


Figure 3.1: Scottish Co-Investment Fund Timeline

Sources. SIB: SCF SE Board Approval Papers, IMRS data and Evaluation of SCFI (Hayton Consulting & GEN op.cit.)

The original objectives of the SCF, set out in a Fund Business Plan prepared in 2002, were referenced in the 2008 evaluation of the SCF commissioned by Scottish Enterprise. They were re-stated in that evaluation as being to:

- Increase the amount of "equity gap" venture capital available to SMEs in a way that did not displace existing investment activity;
- Demonstrate to potential investors that returns could be made by investing in the "equity gap" thereby stimulating the growth of the venture capital industry;
- Increase the number of fund managers operating in the "equity gap"; and
- Attract new investors who had not previously invested in this sector of the venture capital market.

The original rationale for intervention through the SCF, again as re-stated in the 2008 evaluation, was to address a perceived gap in the provision of equity finance in the range of £500,000 to £1m. This gap existed because of a number of market imperfections:

- The perception of high risks associated with these types of investments;
- A lack of capacity in Scotland to fund the numbers of investable propositions that were available. In part this was a consequence of the withdrawal of some venture capitalists from Scotland following market turmoil in the early 2000s;
- The fact that the transaction costs, for example the costs involved in undertaking due diligence, tend to be relatively fixed, regardless of the scale of investment. As such, *ceteris paribus*, there was a tendency to look for larger investments; and
- A lack of capability in the Scottish market for undertaking due diligence for technology based enterprises.

In summary, therefore, the original rationale for the SCF was based on risk aversion, transaction costs and lack of investor capacity and capability in the Scottish equity funding sector.

At the point of establishment in 2003 the SCF parameters were for investment of up to £500,000 in a total deal size of up to £1m, with the proviso that SCF could not exceed 50% of the total investment. In 2007 A discretionary SCF ceiling of £1m was introduced for total deal sizes of up to £2m.

3.3. Interim Evaluation 2008

An interim evaluation of the SCF was commissioned in Autumn 2007 and reported in May 2008[5]. The evaluation concluded that:

"the Co-Investment Fund was attaining its objectives and was held in high regard by all parties: partners, investees, non-partner intermediaries and non-partner investors. The "model" being used (placing the private sector in the lead and the speed and flexibility of its processes) was widely praised. The Fund was also having a positive impact upon the performance of the investee SMEs and upon the wider Scottish economy."

The interim evaluation also re-visited the rationale for the SCF based in market failure and concluded that:

[5] Evaluation of the Scottish Co-Investment Fund. 2008. Hayton Consulting & GEN.

"the initial rationale for the Fund is still justified in that early stage SMEs find raising capital difficult, for both supply and demand side factors."

The interim evaluation also identified a positive contribution from SCF in addressing early stage equity investment capacity through increased volume of funds available for investment and capability (through development of the angel syndicates). However, it was also noted that the SCF was unable to fully address some aspects of market failure which were the result of wider external shocks to the corporate finance market. It was further suggested that the equity gap identified as part of the original rationale for SCF had shifted beyond the then extant £0.5m ceiling on investment and that a case existed for the raising of the ceiling to £1.0m.

3.4. Current SCFII Programme

Following a successful ERDF application for continuation of the SCF, SCFII became operational in 2008 with objectives and anticipated outcomes identified in a Fund Business Plan[6]. This Plan projected investment in 160 businesses over the period between 2008 and December 2015 from a recapitalised SCF with contributions of £40m from SE and approved ERDF funding of £26.7m. The co-investment model assumes £:£ matching therefore the minimal private sector investment Partner funding was £65.2m (excluding a revised £1.46m of fund running costs included in the ERDF application).

The first SCFII deal was concluded in November 2008.

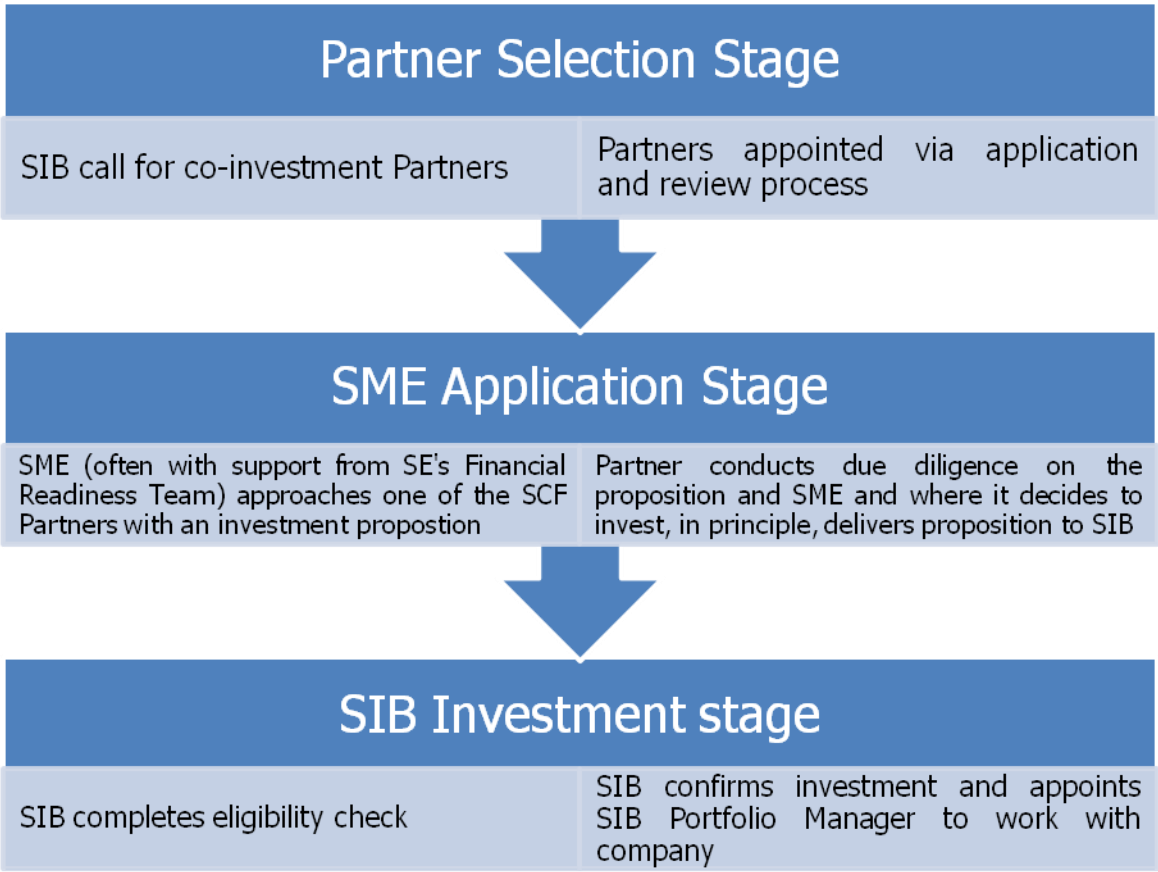
3.5. Current SCFII Process

The SCFII process in operation up to the time of this evaluation has been structured around the three core stages illustrated in **Figure 3.2** (overleaf).

The SCFII is a Partner-led investment fund with the Partners performing all of the client-facing functions of the Fund at the deal origination and transaction stages. Post investment, SIB assign a Portfolio Manager to the company to manage the SE investment interest. Their role includes working alongside the SCF partner to generate investor value, and with colleagues from across SE who are able to draw on wider SE company building support.

[6] Scottish Co-Investment Fund 2008-2015. Business Plan. November 2007. Scottish Enterprise.

Figure 3.2 SCFII Core Stages



3.5.1. Partner Selection

At commencement of SCFII the Partners constituted a combination of those already engaged from SCFI and new SCFII Partners. At the time of commencing this evaluation there was a total of 29 SCFII Partners listed on the SIB website. The new Partners were selected by SIB through a process involving application, review and selection. Following selection, Partners were allocated varying amounts of SCFII per annum for draw-down for investment in SMEs engaged in eligible activities. The amounts allocated to the Partners varied dependent upon their experience and capacity to deliver the match funding required to draw down SCF funds.

The Partners operate together alongside other non SCFII Partner investors in the risk capital market for SMEs, seeking investment propositions which will provide optimal returns to their owners and investors.

3.5.2. SME Applications

SMEs approach SCFII Partners in the course of seeking finance to grow their businesses. They may be aware that the potential investor they are approaching is an SCFII Partner (they are for example identified as such on the SE website) but this will not necessarily be the case.

The SCFII Partner will assess SMEs coming to them for investment and decide on a case by case basis whether they wish to offer SCFII to the businesses as part of their investment proposition. Whether an offer of SCFII is made to the business will include consideration by the Partner of the scale of funding required, the underlying risk profile and an initial consideration of whether the investment is required to finance SCF-eligible activity. In all cases (with or without SCF funding) the Partner will initiate due diligence at this point if it decides to proceed towards an offer of investment.

3.5.3. SIB Investment

If, after the process of due diligence, the Partner proposes to offer SCFII, and the potential investee business wishes to take up the option of SCFII funding, the Partner will approach SIB requesting a draw-down of SCFII from the allocation of funds available to the Partner.

On receipt of this request SIB will complete an eligibility check to confirm that:

- The investment is being made in a commercially-viable company.
- The investee business has or is in the process of developing, a significant operational presence in Scotland which is proportionate to the levels of investment being sought.
- The investee business falls within the EU definition of a Small to Medium Enterprise (SME).
- The proposed investment will not be funding ineligible activities as defined in Appendix 1 to this report.

If, following completion of the foregoing, SIB confirms investment can be drawn down from the Partner allocation, SIB becomes an investor in the business on pari-passu terms with the Partner. Following investment, the company will be assigned a SIB Portfolio Manager (PM) to oversee the investment and represent SIB interests as an investor and promoter of economic development in Scotland. Normally, where the invested business is not Account Managed at the time of investment, the PM will facilitate its engagement with SE as an Account Managed business. The Account Manager will then assist the business in accessing complementary support to optimise application of investment to the development of the business.

3.5.4. Process Operation

The process, as described above, does not operate in a vacuum. In reality, some of the invested businesses may have pre-existing relationships with:

- SE – through Account Management, High Growth Ventures (formerly the High Growth Start-up Unit) or Sector Teams.
- SIB - through previous investment in another fund, such as the Scottish Seed Fund.
- The SCFII Partner, through previous investment by the Partner or by one of its syndicate of investors.

In some cases the invested business will have had support from SE in the form of financial readiness support in advance of approaching the SCF Partner. Some businesses seeking investment may approach one or more SCF Partners and have the option of SCF as part of investment offers from all of the Partners.

It is also the case that business leaders may have a pre-existing awareness of the availability of SCF – either from previous use of SCF in their current or in a previous business, or from speaking to other business owners or investors. These individuals may actively seek out SCF investment and only approach Partners who can offer the enhanced scale of investment facilitated by SCF.

Moreover, as working relationships have become established and Partners have gained experience in the operation of SCF, the Partners are in a position to take informal soundings from SIB on issues such as eligibility and positions on follow-on investment before decisions on whether to progress a particular case for SCFII investment through the process.

4. MARKET CONTEXT

4.1. Introduction

In this review of market context we concentrate specifically on the performance of the *equity* market within the deal space, value and propositions typically considered and funded by SCF – early stage potentially high growth businesses often developing or applying leading edge technologies to products or services with international market potential.

This review is based on recent market commentary and reviews of the period and is supplemented by feedback from the primary research we have conducted amongst the SCFII-invested businesses and Partners in the course of the evaluation.

The SCFII period of operation has spanned the aftermath of the Global Financial Crisis (GFC) of 2007. The objectives and anticipated outcomes of the Fund were established at a point in early 2008 when the GFC was still unfolding, whilst in 2015 the repercussions of GFC are continuing to affect supply and demand for corporate finance.

4.2. Context for Private Equity Investment in Small Businesses

The most current assessment of the state of the UK market for private equity investment in the SCFII deal space was published by the British Business Bank in March 2015[7]. A summary of this report, prepared by SIB, is included as **Appendix 2** to this report.

The report included a stylised funding escalator (reproduced in **Figure 4.1** overleaf) which provides a useful frame of reference in understanding the range of sources available to businesses seeking finance in the UK.

This escalator typifies the businesses operating in the current SCF space as pre-revenue, or revenue producing but pre-profit, often with low levels of tangible assets and aspirations to grow revenue significantly.

The report further concludes that external equity investment is vital "*For a specific group of businesses with the potential for high growth, but whose risk level makes bank finance unsuitable or unavailable".* This group of smaller businesses seeking finance through external equity represents a very small proportion (assessed at 1%) of all businesses seeking finance[8]. However their profile and potential importance to the growth of the economy merits policy intervention and public support to provide access to equity finance. It is further suggested in the report that, whilst there is no typical small business receiving VC or Business Angel investment, they are often more likely to be:

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[7] Equity Research Report. Review of Equity Investment in Small Businesses. British Business Bank and DBIS March 2015 http://british-business-bank.co.uk/wp-content/uploads/2015/03/050315-Equity-report-FINAL.pdf

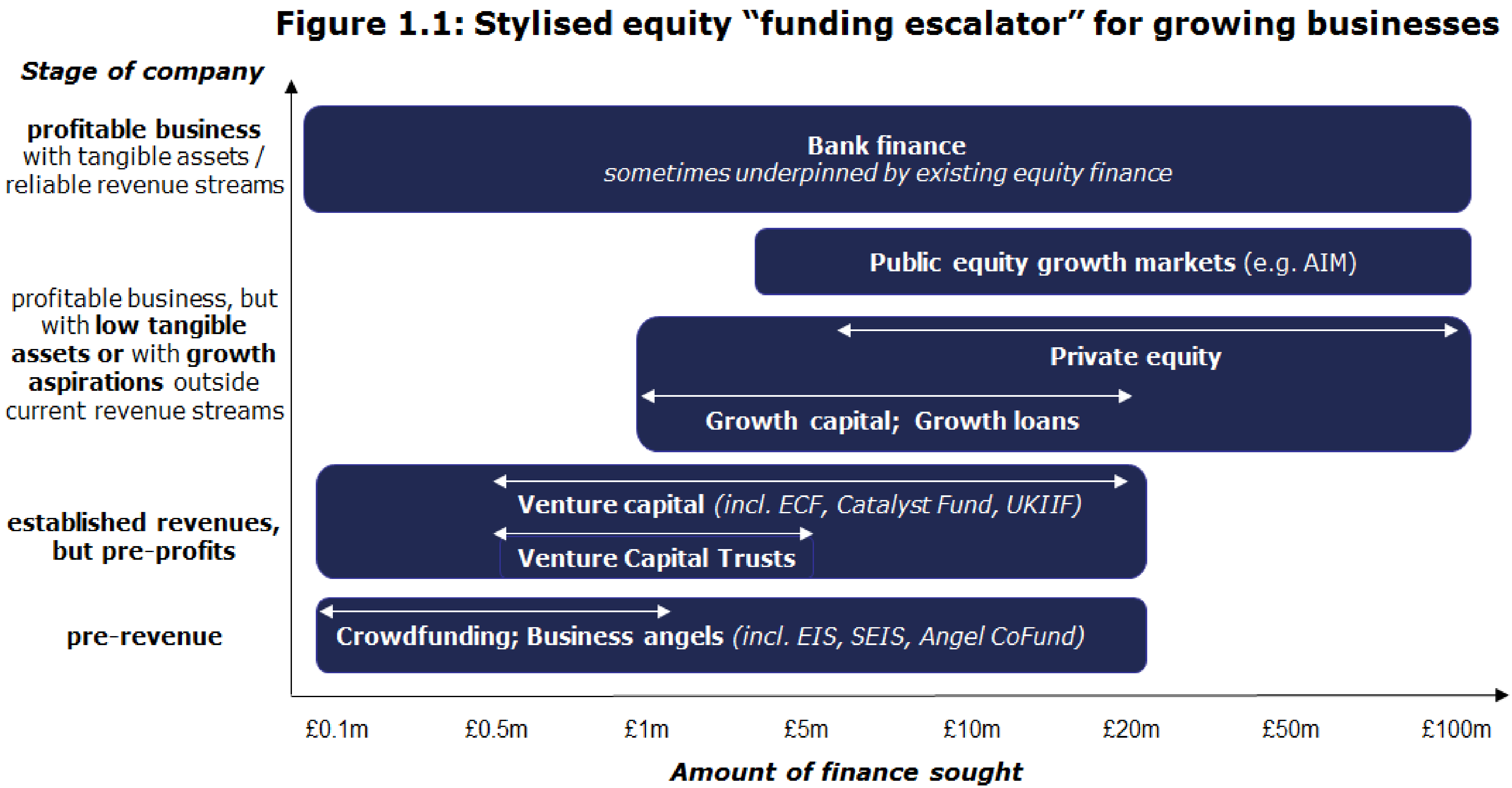
[8] Op Cit. British Business Bank and DBIS. March 2015. Page 9 and references therein to SME Finance Monitor.

- Small, young and at an early stage of development (early or even pre-trading);
- A risky proposition lacking assets to use as collateral;
- Developing a disruptive product or business model; and
- Either growing rapidly, or with the potential for rapid growth.

Whilst not all SCFII invested businesses fit this model, the knowledge gained through our evaluation consultations with 50 cases would suggest that many do fit some or all of the above criteria.

Although many of these businesses lack the collateral to secure, and revenue to service, traditional debt finance their potential for significant growth and concomitant financial returns provide opportunities for risk-receptive equity investors. The potential for significant economic benefits means maintaining an adequate supply of investment capital is a priority for economic development policy makers and delivery bodies.

Figure 4.1 Stylised Funding Escalator (Reproduced Figure 1.1 from British Business Bank Review of Equity Investment in Small Businesses)



4.3. Trends in Private Equity Investment in Small Businesses

4.3.1. UK Market Trends

At the UK level the recent research from the British Business Bank[9] (BBB) has identified a series of trends in the provision of private equity in the Seed, Venture and Growth markets. The current SCF deal space is most closely correlated with the Seed and Venture markets.

The BBB research suggests consecutive growth in private equity funding over the past four years with the strongest growth in the Seed and Growth markets. In the Seed market this is attributed to an increasingly active environment engaging angels, crowdfunding and managed funds. This has in turn been stimulated by tax reliefs provided through a range of schemes including the Enterprise Investment Scheme[10] (EIS).

In contrast, the Venture stage levels of investment are broadly flat from 2011, with some fluctuation from year to year. The research suggests a particular gap in the £2m - £5m deal range within the Venture stage. This emerging gap has been reflected in recent raising of the deal size limit on the BBB Enterprise Capital Fund to £5m and the previous increase (in 2012) of the Venture Capital Trust and EIS limits to £5m.

The BBB research comments specifically on UK trends in Angel investment, context which is of particular relevance to SCFII, where many of the Partners comprise Angel Syndicates. Particular issues identified in relation to Angels include:

- Persistent but slowly improving levels of awareness of Angel investment as a means to invest in young growing businesses on the part of potential High Net Worth Individual (HNWI) angel syndicate members.

- Similarly low levels of awareness of Angel investors as a potential source of investors amongst businesses seeking growth finance. Awareness of Angel investment lagged that of Venture Capital amongst businesses seeking finance and only 15% of those surveyed by BBB knew how to begin the process of securing Angel investment.

The BBB research also highlights anecdotal market evidence suggesting more syndication of angels to fund larger investments increasing deal sizes. The contribution of co-investment funds to this process and accompanying increases in "professionalisation" of investment is also recognised.

There is also recognition of the significant and important role of government in developing the angel market. This is related to both provision of co-investment funds by the public sector, as in the case of SCF, and also in the provision of tax relief to investors, in the main through Enterprise Investment Scheme (EIS) and Seed Enterprise

[9] Op Cit. British Business Bank and DBIS March 2015
[10] EIS is a UK initiative operated by HMRC. Further details can be found at: https://www.gov.uk/government/publications/the-enterprise-investment-scheme-introduction/enterprise-investment-scheme

Investment Scheme[11] (SEIS). The BBB concludes that, together, these initiatives have served to stretch the scale of investments which can be achieved by Angel investors and contributed to bridging the wider equity gap faced by growing businesses. They further conclude that the significant contribution of government to the angel market in the UK is justified because it provides access to funding for "viable, risky high potential SMEs that might otherwise not receive the funding they need". The report also suggests that in providing this support the public sector is promoting a market for and culture of angel investment which should lead to a reduction in the need for intervention in the future.

Other notable trends identified in the BBB research were a decreasing proportion of Venture equity being provided by private equity and venture capital investor groups and greater proportions coming from government, angel syndicates and crowdfunding sources. Of particular note, at a UK level was the rapid growth in the amount of crowdfunding, albeit from a low base and still representing a small proportion of total investment.

4.3.2. Scottish Market Trends

Within the Scottish market we have reviewed the Risk Capital Market in Scotland Report for the years 2012 and 2013[12]. The main findings from this research are:

- Steady numbers of deals with substantial increases in the volume of investment with increases in average deal sizes.
- Increasing domination of investment totals by smaller numbers of larger deals. In 2013 the top twenty deals accounted for three-quarters of all investment – compared to two-thirds in 2012.
- Angel-sourced investment ranging between £14m and £17m per annum over the period 2008-13.
- Angels dominating the mid-range investment band (£100k to £2m) representing 35% of all investment, with much of the 29% of public sector investment in this sector comprising SCFII match from SIB.
- A considerable increase in the number and value of first time investments (businesses securing equity investment for the first time) between 2012 and 2013.

These findings suggest that the Angels, and matching SCF, represent a significant proportion of the total private equity investment in small businesses within Scotland and some evidence of larger value investments becoming more common-place and starting to dominate the market.

The most recent Scottish Risk Capital Market Quarterly Report[13] (Quarter 3 2014) provides further insight to the performance of the Scottish market, although quarterly data appears to be subject to a high degree of volatility. The primary observations were

[11] SEIS is a UK initiative operated by HMRC. Further details can be found at: https://www.gov.uk/seed-enterprise-investment-scheme-background
[12] Scottish Enterprise. The Risk Capital Market in Scotland 2012-13. Young Company Finance Scotland.
[13] Risk Capital Market Reporting Quarterly Report. Quarter 3 2014. Young Company Finance Scotland.

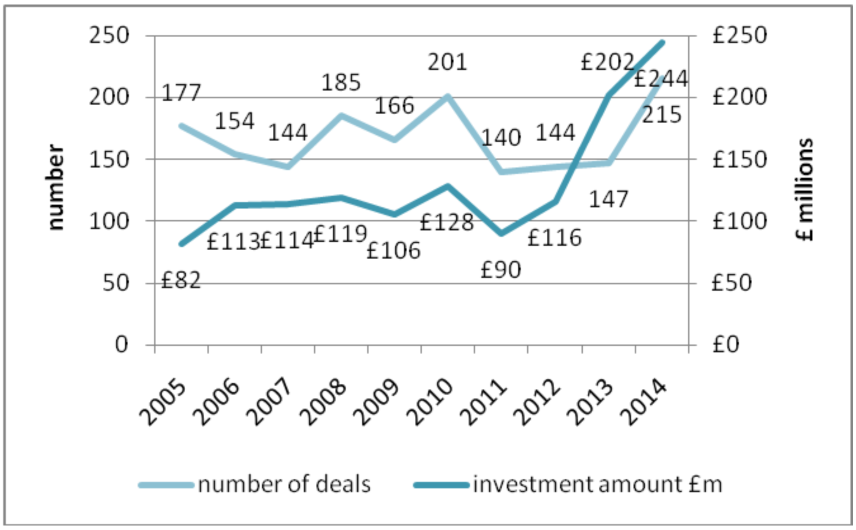
the increase in number of deals year on year by 29% and in the value of investment by 110%. However these figures were distorted by two unusually large VC deals. In the middle market (£100k to £2m) the value and number of investments had declined on the same quarter in the previous year – although they were higher than the average for the two years preceding 2013.

Emerging findings and data for the full year to end of 2014, to be incorporated in the 2014 Risk Capital Market in Scotland Report[14], have also been provided by SIB. This gives a fuller picture on trends over the previous three years. Data on the number and value of deals in the period since 2005 has been analysed by Young Company Finance Scotland (YCF) and plotted in the graph reproduced from their forthcoming report in **Figure 4.2** below.

This analysis confirms the trend of increasing average deal size identified in the 2012 and 2013 data with the number of deals in 2014 increasing by 45% over 2013, and the amounts invested up by over 20%.

The substantial increases in the value of investment made is identified by YCF as being due to a larger number of high value deals in 2013 and 2014, which are also considered as becoming an established feature of the market in Scotland. YCF further comment from their knowledge of the risk capital market outside Scotland that this tendency to large deal size is a universal phenomenon.

Figure 4.2: Deal Numbers and Invested Values Scotland. 2005-14

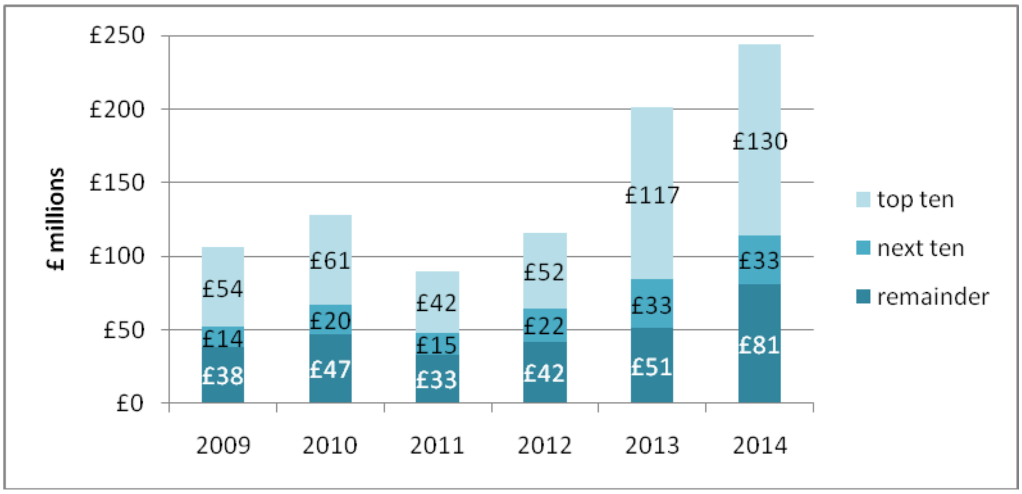


Source: YCF Scotland Data for forthcoming Risk Capital Market in Scotland Report 2014.

YCF have conducted further analysis of investment by deal size which produces strong evidence of the growing influence of large deals on the total investment. This analysis is demonstrated in **Figure 4.3**, extracted from their forthcoming report.

[14] The Risk Capital Market in Scotland 2014, Young Company Finance. Forthcoming.

Figure 4.3: Focus on Top twenty deals 2009-2014

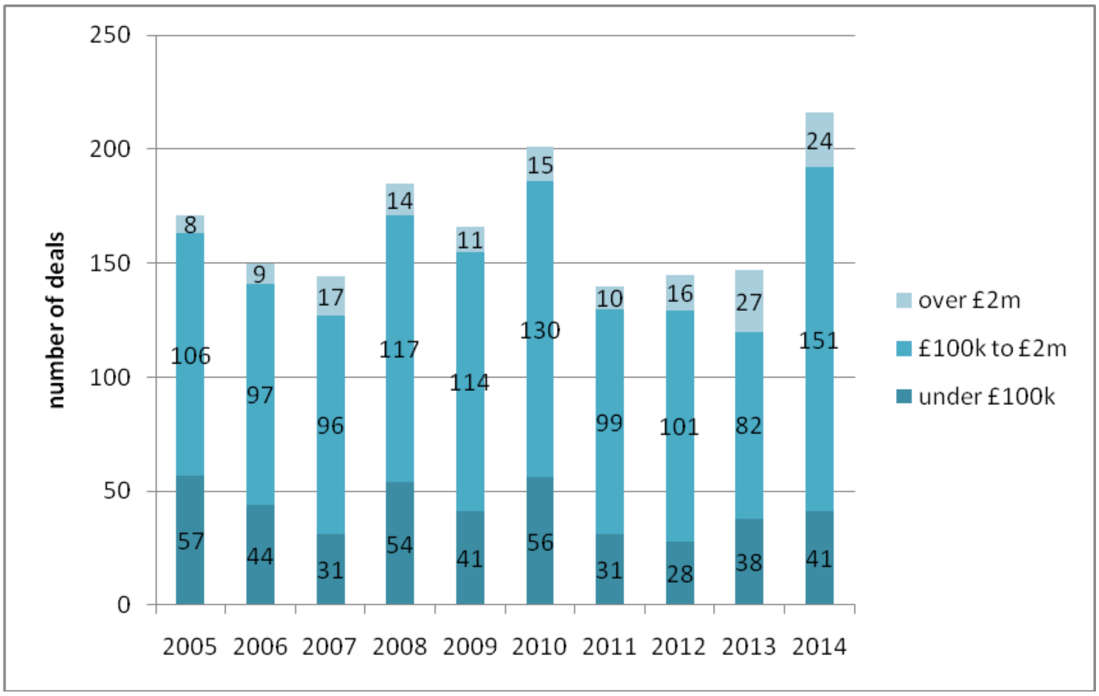


Source: YCF Scotland Data for forthcoming Risk Capital Market in Scotland Report 2014.

Taking this analysis a stage further YCF note that in the past three years, the top three deals accounted for a substantial share of total investment (2012 - £22m; 2013 - £73m; 2014 - £82m), reinforcing their conclusion that overall funding levels are very much dependent upon the number of large deals.

Commenting on the analysis of number of deals by size band (illustrated in **Figure 4.4**) YCF note the consistently low proportions year on year of investment in the under £100k band (recognising that this sector of the market is under-reported due to numbers of investments made by non-syndicated business angels). They also highlight the growth in the number of deals in the £100k to £2m band which they characterise as the "middle band" of investment deal size.

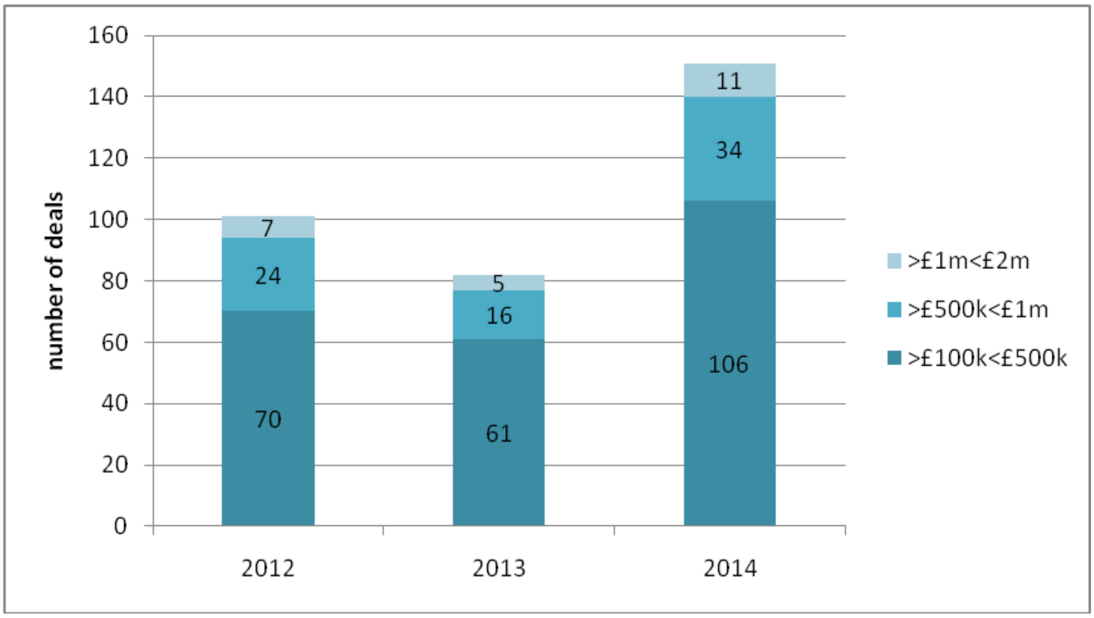
Figure 4.4: Number of Deals by Size Band 2005-2014



Source: YCF Scotland Data for forthcoming Risk Capital Market in Scotland Report 2014.

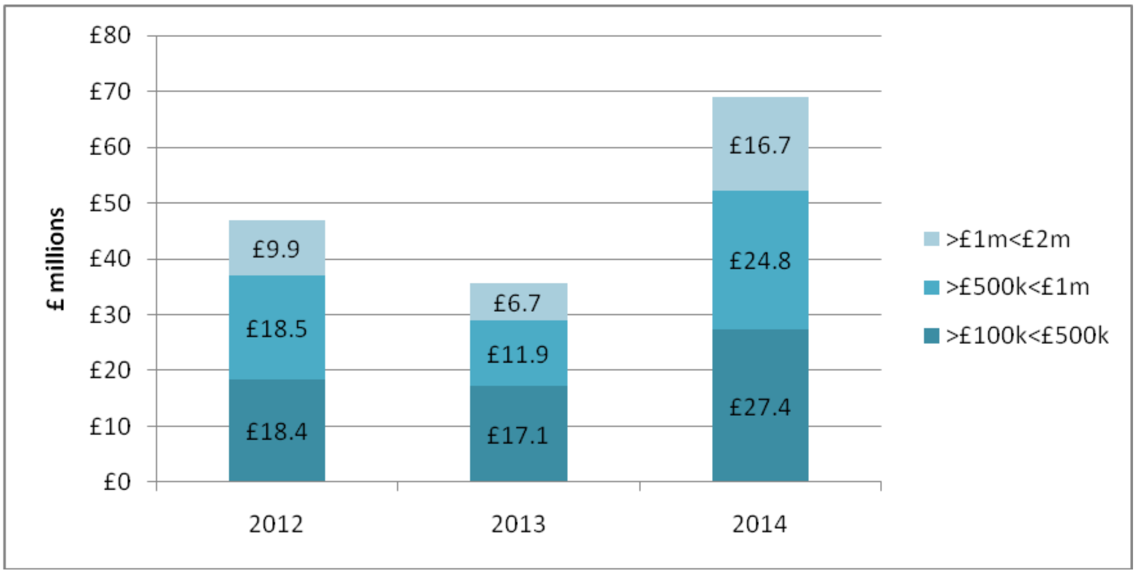
This middle band of investments is where the majority of angel investments are made and YCF have further dis-aggregated this market space into three bands (£100k to £500k, £500k to £1m and £1m to £2m) to further investigate the dynamics of the numbers and value of investments. This is reproduced in **Figure 4.5** for number of investments and **Figure 4.6** for the value of investment. From this analysis, YCF conclude that: *"following a decline from 2012 to 2013, investment in all three categories of this middle band has increased substantially, both in terms of numbers and of investments."*

Figure 4.5: Middle band, breakdown by number of deals 2012-2014



Source: YCF Scotland Data for forthcoming Risk Capital Market in Scotland Report 2014.

Figure 4.6: Middle band, breakdown by value of investment 2012-2014 (£m)



Overall it is concluded that this middle band (£100k to £2m) has become a preferred range for investments by angel groups, accounting for 72% of their total deals by number, and 87% by value in the period between 2012 and 2014. YCF contrast this with the activities of VCs and institutional investors (excluding public sector agencies) who made 56% of their total investments by number, but only 10% by value, in this band over the same period. A slight increase in VC activity in this band is also recorded by YCF for 2014 with VCs making 25% of their investments in this space in 2012-14 compared to 21% in 2012-13.

Additional perspective on the Scottish market is provided by the report of the Royal Society of Edinburgh Joint Working Group published in June 2014[15]. This concluded that:

- The escalation of businesses from angel funding to next step venture capital funding was not operating smoothly with differences noted in the motivation and criteria of both parties meaning they did not always mesh in driving forward the businesses.
- There was a noted requirement for a greater amount of follow on investment from angel investors as other sources of working capital dried up – reducing the amounts available for new investments.
- The period to exits from investments was lengthening to (typically) 10 years – reducing the flow of recycled resources for re-investment in new and growing businesses.

[15] The Supply of Growth Capital for Emerging High Potential Companies In Scotland. Royal Society of Edinburgh, Scottish Financial Enterprise and ICAEW, June 2014.

4.4. SCF Partner Perspectives on The Scottish Market and the role of SCF

In our consultations with the SCF investment Partners we sought feedback on their assessment of the current state of the equity investment market in Scotland.

With regard to the current availability of equity finance in the market space occupied by SCF, views among currently active investors were found to be evenly divided. One group maintained that, with SCF, supply was reasonable and good prospects will get funded. The other group is of the opinion that even with Seed Fund and SCF, demand exceeds supply, particularly for new investments, as seen in the trend towards multi-syndicate funding of new deals.

Certain sectors are perceived as facing particular challenges in accessing adequate funding, notably:

- Life sciences - drug discovery companies have substantial funding needs and a long pre-revenue stage. Medical devices also face uncertainties associated with regulation of their target markets.
- Renewable energy - generally associated with a large scale investment requirement.
- Oil and gas - reflecting the weak outlook for investment in these sectors as a whole.
- Software - seen as a specialised investment requiring in-depth knowledge of niche markets, alongside understanding of the source and persistence of the competitive advantage of the proposed investee business.

Investment partners outside the Central Belt noted that investment has historically been Edinburgh and Aberdeen-centric and that there has been a reticence among investors to operate outside their core geographical area. In some instances, this reflected perceptions of a lack of depth in management teams outside the Central Belt and North East of Scotland. Other investors pointed to structural factors, notably the extent to which investment is driven by university-based research and the distribution of High Net Worth Individuals (HNWIs)[16].

For those involved in the market prior to the financial crisis, the general *perception* was that in the period to 2008, investment levels were higher than at present, to some extent reflecting unrealistic valuations rather than a higher level of demand. Demand was perceived to dip during the financial crisis, but investors vary in their views on how much. Despite the difficulties in raising bank finance, there does not appear to have been a tendency among existing businesses to look to equity markets as an alternative, largely because a working capital deal is unlikely to offer the return that an equity investor is looking for. However, it was suggested that the requirement for personal guarantees under the Enterprise Finance Guarantee scheme meant that new businesses of any scale were now more likely to look towards equity.

Supply was perceived by some as having become constrained in the past 18 months as a result of "investor fatigue" due to a lack of exits. Moreover it was suggested that as a result of the performance of the stock market, HNWIs have not had high levels of capital gain to recycle through angel investment in order to benefit from tax relief.

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[16] The most commonly cited definition of a High Net Worth Individual appears in the World Wealth Report 2013. Cap Gemini and RBC Wealth Management define HNWIs as "those with $1m US or more in investible assets (not including the value of personal assets and property such as primary residences, collectibles, consumables and consumer durables)". http://www.capgemini.com/resource-file-access/resource/pdf/wwr_2013_1.pdf

All investors interviewed, including those no longer active, are of the view that SCF is addressing a valid market failure as regards access to finance for start-up and early stage development. In the absence of SCF there would be a significant shortfall in supply at this level. A small number thought raising the £2m total deal ceiling might be "useful" in some instances, as the current ceiling may be a disincentive to companies to ask for adequate levels of finance required for growth. However, it was also noted that most SCF-backed deals are not constrained by the present limit.

A more severe access to finance market failure was perceived in the £2-5m deal range (some saw this extending to £15m) and this was seen as a contributing factor to SCF investors having to meet additional demand for follow on funding rounds. Some saw a need for angel investment to build bridges with venture capital in order to address a perceived gap in the scale of investment acceptable to Angel investors and the (higher) minimum deal threshold for VC funds.

4.5. SCF-Invested Business Perspectives on The Scottish Market

In our consultations with the SCF-invested businesses we asked for their opinions on current ease of access to finance for businesses in Scotland.

We received a range of responses from over 40 of the businesses we consulted. The responses generally resolve into a series of themes:

- It remains difficult to access next stage finance in deal sizes of over £2m with few VCs active in Scotland and showing interest only in propositions for over £5m of equity in businesses with established revenue streams and beyond a break even position.

- There is a tendency for businesses through lack of ambition, experience or foresight to under-bid for resources - leading to drip feeding of funds in several rounds. This consumes significant proportions of senior management time in securing serial funding rounds to support the development of their business.

- This phenomenon is being reinforced by a perception of angel syndicates preferring an incremental approach to investment and being reluctant to accept dilution by next round investors. There were also suggestions that some angel syndicates lacked the firepower to follow on their investments.

- There are few potential VC providers of next stage investment based in Scotland. Businesses are increasingly recognising a need to go further afield to find investors with the appetite and knowledge of their products and markets to frame the investment risk and realise the potential for growth.

- There is perceived to be little interest in or knowledge amongst potential investors of propositions emerging from the manufacturing and food and drink sectors, with greater appetite for technology, financial services and life-sciences sectors.

- A minority of business leaders consider that funding can still be found for strong propositions put forward by experienced management teams with the skills and persistence to succeed.

We also received feedback from our business consultees on the sectors where they considered funding more difficult to access, the stages of growth where access was particularly difficult and the range of funding where access was most difficult. This suggested that:

- Access was most difficult for businesses in the Life Sciences, Technology, Engineering and Creative Industries sectors.
- Businesses in the Seed and Growth stages were considered to have most difficulties in accessing necessary funding.
- Finance in the deal ranges £500k to £1m and £2m to £5m ranges are considered most difficult to secure.

4.6. Market Failure in the Scottish Risk Capital Market

The rationale for SCF was originally founded in market failure arising from risk aversion, transaction costs and lack of investor capacity and capability in the Scottish equity funding sector (See S3.2 above).

The interim evaluation of SCF, conducted in 2008[17], concluded that the original market failure rationale for the SCF remained valid but also noted that external factors which could not be influenced by SCF operations were contributing to the continuing market failure (See S3.3 above).

Our findings on the risk capital market in Scotland, as detailed in the preceding sections suggest that SCF is addressing a valid ongoing and structural market failure in the supply of risk capital for start-up and early stage businesses. In the absence of SCF in Scotland it is clear that there would be a significant shortfall in supply at this level.

There is evidence to suggest that constraints in the supply of early stage risk capital are the result of ongoing and structural market failure as a result of risk aversion by investors and asymmetric information on innovation activity and market potential between investors and investees. However, whilst this market failure is structural and persistent it is also dynamic. It is influenced by external financial and economic factors impacting across the spectrum of investment risks. It is also subject to variation across sectors and geographies and to innovations in the investment market – including crowd-funding. There is also evidence that the market for early stage business finance is becoming less parochial, with innovative niche businesses seeking out investors across the world with specific experience of their technology and markets.

Our research into the market context as part of a wider evaluation of a specific intervention (SCFII) cannot be wholly conclusive on the nature and extent of market failure in the Scottish risk capital market. We can, however, make the following observations on the market failure in the market space within which SCFII has operated over the evaluation period.

- In the absence of SCFII the value and number of equity investments made in early stage businesses over the evaluation period would have been significantly

[17] Evaluation of the Scottish Co-Investment Fund. 2008. Hayton Consulting & GEN.

lower. The Angel syndicates and SCF together represented 35% of equity investment in small businesses in Scotland in 2014.

- There is evidence of some reduction in the amount of *new* investment from existing angel syndicates as they commit to follow-on investments and await exits from investments.

- There is a growing number of alternative sources of early-stage equity investment from across the UK from: angel syndicates outwith Scotland; crowd-funding platforms; and other tax-efficient investment vehicles facilitated through the Enterprise Investment Scheme.

- There remain perceived gaps in the provision of risk finance in: the sub £100,000 market space - with implications for the youngest and smallest businesses; and in the £2m to £5m market space - which can impede business growth and delay the realisation of angel and SCF investment for recycling into new propositions.

There is also a number of more persistent market failures including fixed transaction costs and associated due-diligence research forming a disproportionately high part of smaller investments. Risk-aversion on the part of equity investors also tends to limit the commitment of investment to pre-revenue businesses. There is also limited evidence on the medium to long term post-investment performance of early stage and pre-revenue investments. There is a potential role here for SIB and the sector in general to make investment performance available to the market over an extended period to encourage potential future investors in the SCF market space.

It is important for SCFII to continue to work with the market in improving the accessibility to equity funding for early-stage businesses. The globalisation and specialisation trends in the investment market offers opportunities for Scottish businesses to source the funds they need to grow from outside Scotland. These trends also provide opportunities for Scottish-based investors and syndicates to sustain and develop their capacity and capability to invest in opportunities outside Scotland.

4.7. Summary Findings on Market Context

Our review of the risk capital market based on published research supplemented by feedback from our consultations suggests that:

- The potential financial returns on investment in early stage businesses with high growth potential attracts risk-receptive investors and is of importance to UK and Scottish policy makers seeking to generate and sustain economic advantage.

- Across the UK there is a growing supply of early stage risk capital from a combination of Angel investors and fast-growing crowdfunding sources. This supply is stimulated by a range of tax-efficient investment models including the Enterprise Investment Scheme (EIS).

- Evidence from Scotland showing that Angel Syndicates, and matching SCF, represent a significant proportion (35%) of the total private equity investment in small businesses within Scotland and some evidence of larger value investments becoming more common-place and starting to dominate the market. Angels provide the majority of investment (87% by value in 2014) in the £100k to £2m deal space with some evidence of VCs becoming more active.

- All investors interviewed, including those no longer active, are of the view that SCF is addressing a valid ongoing and structural market failure in the supply of risk capital for start-up and early stage businesses. In the absence of SCF in Scotland there would be a significant shortfall in supply at this level.

- Some feedback from SCF Partners suggests that the supply of angel capital has become constrained in the past 18 months as a result of "investor fatigue" due to a lack of exits.

- Evidence from research that transition of businesses from angel funding to next step venture capital funding was not operating smoothly, with differences noted in the motivation and criteria of both parties. In addition there has been a requirement for a greater amount of follow on investment from angel investors and the period to exits from investments has been lengthening to (typically) 10 years.

- A tendency for businesses to under-bid for resources - leading to drip feeding of funds in several rounds. This is reinforced by a perception amongst some invested businesses of some angel syndicates preferring an incremental approach to investment and being reluctant to accept dilution by next round investors.

- There are few potential VC providers of next stage growth funding based in Scotland. Businesses are increasingly recognising a need to go further to find investors who understand their propositions and prospects in niche global markets.

- Consistent evidence from <u>all</u> sources of a gap in the provision of equity finance in the £2m to £5m range across the UK <u>and</u> Scotland. This has particular repercussions for SCF-invested businesses seeking next stage growth finance.

5. SCFII PERFORMANCE ANALYSIS

5.1. Introduction

In this section of the Report we provide an analysis of Fund data provided to us by SIB in the form of an extract from their IMRS database. The data is analysed to provide insight to annual investment levels, investment in SE sectors, investment by SCF Partner and new and follow-on investment per annum. We also provide analysis of failure rates and exit performance.

5.2. Total Investment through SCF

Over the evaluation period investment totalling **£45.5m** has been made through the SCF matched by **£74.5m** of Partner investment. This total investment of **£120m** by SCF and Partners, by year, is detailed in **Table 5.1**.

Table 5.1: Annual Investment

Year	SCF Investment	Partner Investment	Total Investment - SCF & Partner
2009*	£ 10,713,789	£ 14,606,911	£ 25,320,700
2010	£ 11,674,613	£ 19,622,044	£ 31,296,657
2011	£ 8,933,791	£ 14,994,849	£ 23,928,640
2012	£ 7,132,184	£ 14,349,776	£ 21,481,960
2013	£ 7,058,044	£ 10,999,147	£ 18,057,191
Totals	**£ 45,512,421**	**£ 74,572,727**	**£ 120,085,148**

* For Period April - December 2009

Setting aside the 2009 data (which relates to a 9 month period) the data for 2010 to 2013 shows an average total annual investment of £23.7m with a reducing trend of annual investment year on year. In 2013 annual SCF investment had reduced by 42% from the 2010 level.

5.3. SCF Investment by SE Priority Sector

The SIB IMRS database tags SCF investment against SE growth sectors. Our analysis of this data identifies significant proportions of 2009-13 SCF investment within the Enabling Technologies[18] (37.2%) and Life Sciences (29.9%) sectors. The data for all of the growth sectors is detailed in **Table 5.2**.

This analysis also provides for the intensity of SCF investment in each sector (up to the maximum contribution of 50% of deal size). The average intensity of 38% compares to a high of 47% in the Energy (other) sector, 44% in the Renewable Energy and Food and Drink sectors and the lowest level of 26% in the Financial Services Supply Chain sector. It is also notable that SCF investment in other sectors, at 48% of total deal size, has the highest intensity of SCF engagement.

[18] The “Enabling Technologies” sector was used by SE in the period 2009-13. It has latterly been combined into a Technology and Advanced Engineering sector.

Table 5.2: April 2009 - Dec 2013 SCFII and Partner Investment by SE Growth Sector						
SE Sector	**SCFII Investment**		**Partner Investment**		**Total Deal**	**SCF % of Total Deal**
	(£)	**%**	**(£)**	**%**	**£**	**%**
Aerospace, Defence & Marine	278,960	0.6%	496,040	0.7%	775,000	36%
Chemical Sciences	414,885	0.9%	893,568	1.2%	1,308,453	32%
Construction	404,569	0.9%	723,999	1.0%	1,128,568	36%
Creative Industries	4,492,599	9.9%	6,642,174	8.9%	11,134,773	40%
Enabling Technologies	16,950,592	37.2%	29,281,203	39.3%	46,231,795	37%
Energy - Other	3,051,470	6.7%	3,829,901	5.1%	6,881,371	44%
Energy - Renewable	1,304,220	2.9%	1,456,049	2.0%	2,760,269	47%
Financial Services	1,267,176	2.8%	3,573,832	4.8%	4,841,008	26%
Food & Drink	1,865,597	4.1%	2,343,833	3.1%	4,209,430	44%
Life Sciences	13,592,950	29.9%	23,272,011	31.2%	36,864,961	37%
Other sectors	1,889,403	4.2%	2,060,117	2.8%	3,949,520	48%
Total	**45,512,421**	**100%**	**74,572,727**	**100%**	**120,085,148**	**38%**

5.4. SCF Investment by Partner

As the SCF is a Partner-led investment fund we have conducted an analysis (**Figure 5.1**) of the value of SCF drawn down by the Partners over the evaluation period. The data provided to us did not differentiate by value on syndicated investments by more than one Partner - so these have been amalgamated in the analysis as "multiple partner investments". We have also grouped individual partners with total investment over the evaluation of period of less than £200,000 to facilitate analysis and presentation.

The analysis demonstrates that whilst 17% of SCF investment is drawn down in syndicated Partner deals, the two most active individual Partners together account for a quarter of all SCF investment drawn down in the period. The top 10 individual Partners, by value of SCF funds drawn down, together account for just over half (51.4%) of the SCF invested over the period.

5.5. New and Follow-on SCF Investment

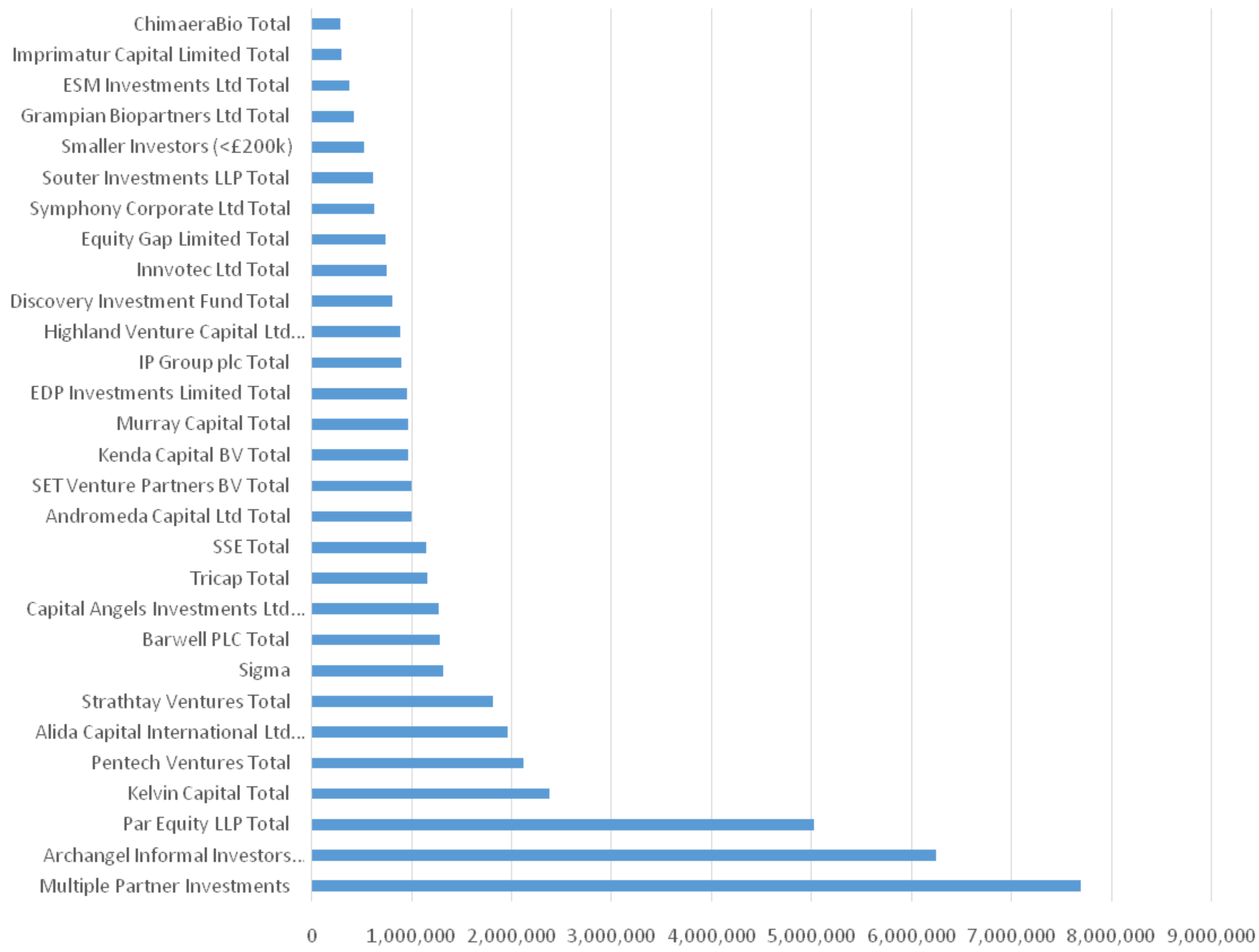
We have interrogated the SCFII data in order to distinguish between new and follow-on investment.

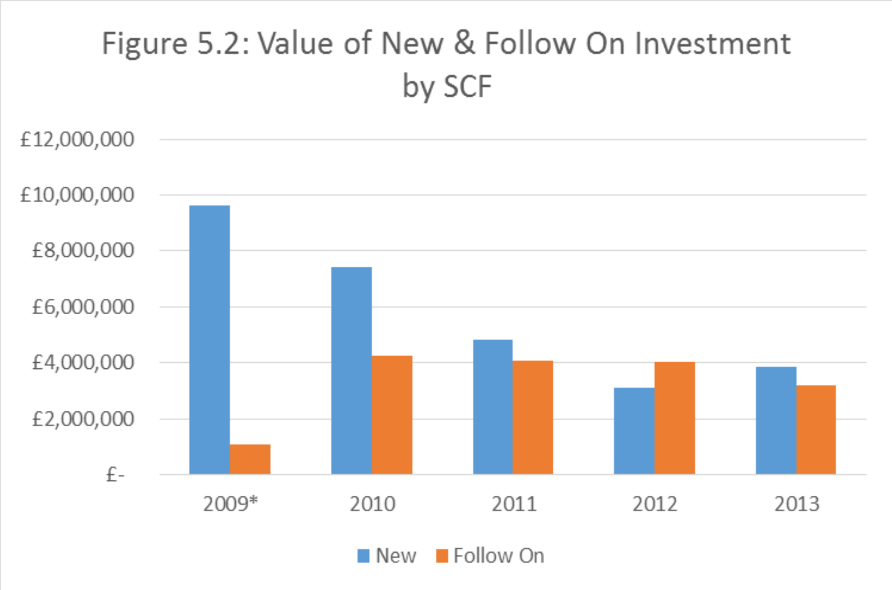
The results of this analysis are illustrated in **Figure 5.2** (SCF investment) and **Figure 5.3** (Partner investment). This analysis demonstrates the growing amount of follow-on investment being required by pre-invested businesses with the amount of follow-on SCF investment exceeding new investment in 2012 and follow-on Partner investment exceeding new investment in 2011 and 2012. There is, however, a modest reversal of this trend in the figures for 2013. Follow-on investment is not considered to be a negative indicator of invested business performance and can be a consequence of a business identifying greater development or expansion opportunities than anticipated at first appraisal. Follow-on is also often anticipated or expected by early stage investors, although prolonged or repeated requirements for follow-on investment can indicate difficulties in accessing or agreeing terms for exit from the investment – for example through a trade sale, Initial Public Offering (IPO) [19] or securing next stage equity and/or debt.

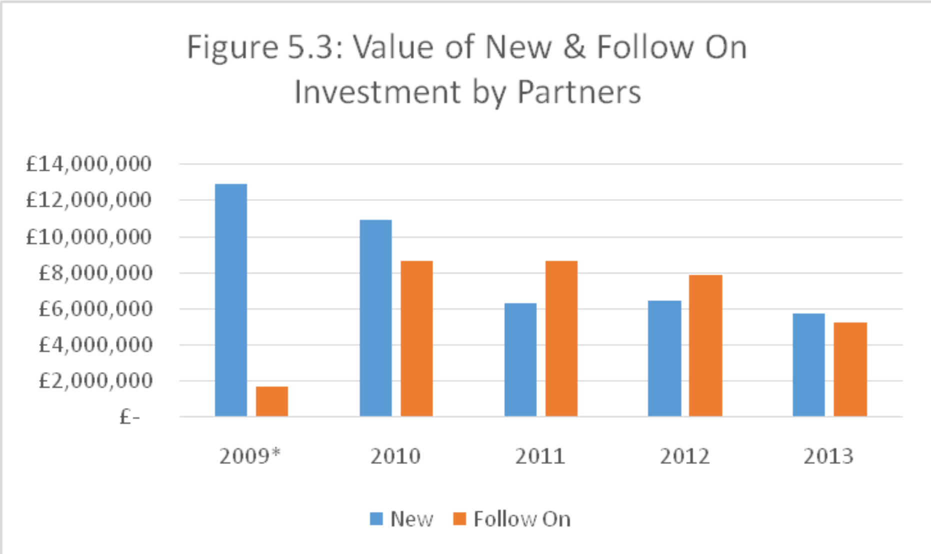
In addition to the year-on-year analysis we have also prepared an analysis of the changes in the proportion of cumulative investment represented by New and Follow-on deals. **Figure 5.4** illustrates the increasing proportion of total fund investment taken up by follow-on deals. In 2009 SCFII follow-on deals represented 11% of total SCFII investment to the end of that year with this proportion rising to just over 40% of total SCFII investment to the end of 2013. Whilst it might be expected that follow-on deals would form a greater proportion of SCFII investments as the Fund matured, this analysis does demonstrate the *potential* impact of commitments to follow-on on the capacity of the Fund to make new investments in the latter half of the evaluation period. However, for this *potential* impact to have an effect it would require there to be un-satisfied demand for new investment from new businesses with viable investment propositions.

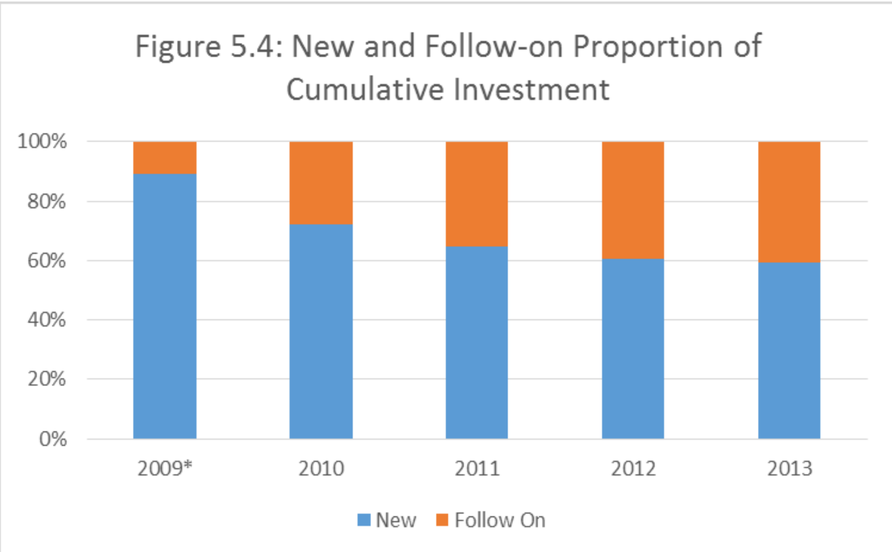
[19] Initial Public Offering (IPO) represents the first offering of share capital to the public by a private company.

Figure 5.1: SCF Investment By Partner April 2009 -December 2013 (£)









* For Period April - December 2009

5.6. Exits and Non-Performing Assets

Using data provided by SIB, we have conducted an analysis of the income from SCFII exits achieved to date, and the losses sustained from writing off of SCFII non-performing assets (NPAs). This is conducted, by financial year for income and losses from Fund investments. The analysis is detailed in **Table 5.3**.

Table 5.3: Income and Losses to Fund Account 2009-2013

Period (FY)	Income		Costs	Net Income	SIB investment in Year	Cumulative SIB Investment	Cumulative Income
	Investment Disposals	Loans Repaid	Investments Written Off				
2009/10	£0	£15,625	£25,000	-£9,375	£11,417,593	£11,417,593	-£9,375
2010/11	£238,069	£550,367	£0	£788,436	£11,482,483	£22,900,076	£779,062
2011/12	£52,050	£23,731	£515,080	-£439,300	£9,119,407	£32,019,483	£339,762
2012/13	£1,793,342	£345,743	£1,109,999	£1,029,086	£7,072,819	£39,092,302	£1,368,848
Totals	£2,083,462	£935,466	£1,650,079	£1,368,848	£39,092,302		
Investment Written Off as % of Cumulative Investment Value 2009-13							**4.2%**
Income Received as % of Cumulative Investment Value 2009-13							**7.7%**

The analysis demonstrates a *positive net income* to the Fund over the period to the end of financial year 2012/13 of **£1.37m** taking account of receipts from disposals and investments repaid, and costs from investments written off. However, it should be noted that this does not take account of SIB's staff costs although these are factored into the later impact calculations (see 8.7 Value for Money Assessment). Their inclusion would increase costs and decrease the returns. The proportion of investment written off in relation to total investment is running (at the date of the evaluation) at a rate of 4.2% of SIB investment through SCF to the end of FY 2013. Income received over the same period is equivalent to 7.7% of SIB investment made through SCF to the end of FY 2012/13.

5.7. Summary Findings

Our analysis of the data on the SCFII investments provided by SIB has demonstrated:

- The data for 2010 to 2013 shows an average total annual SCFII investment of £23.7m with a reducing trend of annual investment year on year. In 2013 annual SCFII investment had reduced by 42% from the 2010 level.

- Significant proportions of 2009-13 SCFII investment were made within the Enabling Technologies[20] (37.2%) and Life Sciences (29.9%) sectors.

- The average SCFII investment intensity of 38% of total deal size compares to a high of 47% in the Energy (other) sector, 44% in the Renewable Energy and Food and Drink sectors and the lowest intensity of 26% in the Financial Services sector.

- Growing amounts of follow-on investment being required by pre-invested businesses with the amount of follow-on SCFII investment exceeding new

[20] The "Enabling Technologies" sector was used by SE in the period 2009-13. It has latterly been combined into a Technology and Advanced Engineering sector.

investment in 2012 and follow-on Partner investment exceeding new investment in 2011 and 2012. There is, however, a modest reversal of this trend in the figures for 2013.

- A positive net income to the Fund over the period to the end of financial year 2012/13 of £1.37m taking account of receipts from disposals and investments repaid, and costs from investments written off. The proportion of investment written off in relation to total investment is running at the date of the evaluation at a rate of 4.2% of SIB investment through SCFII to the end of FY 2013.

6. SCFII INVESTMENT PARTNER FEEDBACK

6.1. Introduction

In this section of the report we present the feedback from our consultations with a selection of SCFII Investment Partners. The SCFII Partners are responsible for identifying, appraising and performing due diligence on potential investments to be matched by SIB through SCFII.

A total of 13 Partner Consultations were conducted from a selection of 16 SCFII Partners identified by SIB as having a wide range of experience of the operation of the Fund. Three of the identified Partners elected not to engage in consultations, either because no single representative could provide comprehensive feedback on SCFII, or because current staff had little experience of SCFII investments. All Partner Consultations were conducted face-to-face with principals in each of the Partners on a non-attributable basis.

It should be noted that our research amongst the Partners, whilst structured and conducted using a consistent topic guide, was designed to provide qualitative and contextual feedback on the SCF process, the effects of SCF on investment decision making and scale in general terms. Due to limitations on the amount of time Partners could make available for these consultations we could not investigate individual investment decisions made by the Partners using SCF. This generic but valuable feedback we received from Partners has not been applied to the assessment of the potential economic impacts of SCFII investments presented in Section 8.

In the following sub-sections we consider:

- The profile of the Consulted Partners
- Their motivations and rationale for becoming a SCFII Partner
- Effects of SCFII on Investment Approach
- SCFII Deal Flow
- Performance of SCFII Investments
- Investment management and administration
- Improvements to SCFII suggested by Partners

It should be noted that opinions we received from the Partners on the performance of the investment market and the rationale for the SCF have been reported in Section 4 (Market Context).

6.2. Consulted Partner Profile

The consultations included the two largest single investing Partners, together accounting for over 25% of the SCFII drawn down over the evaluation period.

Together these investors accounted for 92 cases where they were the sole investor in partnership with SCFII and a further 11 investments where they were involved as a member of a syndicate alongside other SCF Partners.

Within the sample there was a broad spectrum of experience with SCF ranging from investors that had been involved from the start and had contributed to the original protocols to those that had become Partners relatively recently.

6.3. Partner Motivation and Rationale

The principal motivations for Partners becoming involved in SCF were

- the possibilities presented to fund more investments and higher levels of investment in opportunities where this was appropriate.
- the sharing of risk and, in particular, exposure of risk to follow-on funding needs.

The spreading of risk was highlighted by only a couple of Partners, seemingly reflecting the fact that angel syndicates, which represented most of the sample, provide for members to be selective in the number of deals they participate in and on the scale of investment they input to these deals.

The rationale and commercial case for involvement with SCF over time appears to have remained stable with some provisos. It has been modified by:

- Greater appreciation of the scale of funding that businesses are actually likely to need, as seen in a number of investors focusing on follow-on investment needs.
- Improved understanding of valuation and the need to avoid paying too much for a given share, particularly in relation to businesses spun out of university research.

6.4. Effects of SCF on Investment Approach

For Scottish-based investors, SCF has increased the number of deals completed in Scotland. For example, an angel investor noted that SCF enabled some deals to go ahead where otherwise there would have been insufficient interest and required scale of investment from their members.

SCF has also resulted in some deals being larger than would otherwise have been the case. In these circumstances this is seen as beneficial for the businesses in providing resources to make a step change or in extending the period to the next funding round.

The positive effects on number and size of deals mean that the total volume of investment has increased.

Investors are clear that partnership with SCF has not influenced willingness to invest in *individual deals* with a higher risk profile – in essence the availability of SCF is not making investors invest in propositions which they otherwise would have rejected. However one investor did believe that partnership with SCF may have had some effect on the balance between investment in early stage and existing businesses with a greater propensity to invest in the former. This points to SCF assisting in spreading risk and adapting investor behaviour across their portfolio of investments.

No Partner reported that they appraised SCF and non-SCF funded business differently. All equity investments are perceived to be risky, particularly new ventures, and Partners only take up a very small proportion of the prospects placed before them. They understand the odds, but at the point of initial commitment they believe they are investing in a potential winner.

Most Partners who had a significant and continuing involvement in the Scottish market reported that they will use or consider use of SCF in all eligible investments. In the case of angel investors, there may be instances where syndicate member interest in investing exceeds the cash needs of the business negating the need for SCF co-investment. Three Partners reported that they fully funded investments in SCF-eligible activities where businesses were bought out of administration and where SIB was unwilling to co-invest. A small number – mainly larger Partners – noted the emergence of Enterprise Investment Scheme (EIS) vehicles as a competing source of co-investment.

6.5. SCFII Deal Flow

Partners report that the deal flow has varied over the evaluation period with a complex interaction of trends reflecting the business cycle and sectoral fashions. The translation of demand into deals has also been affected by clarification of follow-on investment requirements. There is some suggestion that good prospects that were placed on ice in 2009-11 started coming to market in 2012, resulting in an apparent increase in quality, but that these postponements are now reducing as a proportion of total investments.

No trends in the quality of proposals were noted by sector or geographic area. The average presentation of proposals was considered to have improved to some degree although it was still mixed. This was thought by some to be as a result of greater engagement of young businesses with investment-readiness support provided by business support agencies and the engagement of professional advisors in business plan writing. Views were mixed on whether the fundamental quality of propositions has actually improved.

6.6. SCFII Investment Performance

The investment made in businesses with SCF support is seen as having enabled them to develop technology and products, to test market reaction and, where gaining traction, to progress to the next stage of development.

Partners have fairly similar expectations in terms of the likely out-turns of their investment, typically out of ten investments:

- 1 will sell on with a high multiple return on investment.
- 1 will sell on with a modest multiple return on investment.
- 3-4 will recoup the investment.
- 4-5 will fail.

In terms of performance of the SCF-supported businesses, Partners do not report that their experience in terms of failures is outside these expectations and some are optimistic about the prospects for good returns.

What is different to expectations is the timescale to exit and the number of exits to date. Many initial investments were made at a point when the number of years to exit was at an historic low. Some investors reported that at the time of these early investments they had anticipated exits in 5 years, a timescale which is less than an historic average of 7-8 years identified by other Partners. At present, timescale to exit is reported as taking closer to 10 years and perhaps longer in the case of life sciences.

Longer established Partners stressed the "long game" nature of investing: you need patience to wait for the right investment; you need patience and deep pockets to build value; you will take your losses before your wins.

The paucity of exits is attributed to the withdrawal of venture capital from deals below £5m and also the hiatus in merger and acquisition (M&A) activity. M&A reduced sharply in 2009-12 as corporates focused on cash flow. It was reported that M&A activity has resumed, corporations are cash rich and the Alternative Investment Market is improving.

Some Partners note a need to galvanise management on the need to prepare for exit and that they are increasingly likely to "rock the boat" by encouraging management to focus on the potential for and means of exit. One corporate investor had exited by placing a number of investments in an independently managed fund and others saw some merit in a similar approach.

While no Partner reported that their experience with SCF had negatively impacted on their perceptions of investment in Scottish businesses, it is nevertheless the case that some report that their investment priorities have changed. Some are focusing on other priorities (e.g. crowd funding); some report that they are still looking for new prospects but that member investors are reticent in committing to new investment. It is unclear to what extent future disposals will result in the funds realised being reinvested by investor members.

6.7. Investment Management and Administration

We asked the Partners to describe how they were involved in the management of their SCF-invested businesses.

In all but one case investors reported that they would be represented on the Board of their SCF invested businesses either directly, via an investor member, or through the appointment of a non-executive director. Where an investor-director was appointed in smaller businesses, they quite often adopted the role of Finance Director.

In addition, Partners were found to be feeding-in expertise. Sometimes this would be additional time contributed by the investor beyond board representation as part of the monthly management fee. One was acting as Finance Director in its more significant investments and noted that fees were covering only 60-65% of the cost of support.

Other investors noted that they were providing access to expertise within their membership or their network of specialist advisers. Some of this is provided free of charge, but companies were generally expected to pay for more significant inputs. In some instances, advisers were prepared to take payment in "sweat" equity, where the value of their input to the business is converted at a pre-determined value into an increased share in the ownership of the business.

6.8. Fund Management and Administration

We also asked the Partners about the ongoing management of SCFII and their interactions with SIB. All 13 investors interviewed continue to believe that the co-investment principle remains relevant and that the SCF model can provide an efficient market-led way for SIB to increase the volume of funds available for equity investment in small and growing Scottish businesses.

A number of investors, all presently active in the Scottish market, considered that the SIB role was most efficient and effective when SIB:

- acted as a co-investor rather than a syndicate investor assessing follow-on investments on a case-by-case basis.
- empowered the Partner to control the due diligence process in relation to legal and commercial risk.
- minimised its role in the management of investments, including the appointment of Non-Executive Directors (NXDs). However, this is perceived as potentially beneficial if these NXDs are relevant, well qualified and add value, but recognising it adds significantly to the cost of capital for the business and needs to be taken into account in deal planning.

Some concern, was highlighted in relation to the proportionality and costs associated with legal process and some were of the view that through the role of its lawyers, SIB appears to be obtaining a preferential position relative to Partners in some instances.

The foregoing needs to be considered in the context of SIB working closely with more recently appointed and less experienced Partners to ensure that investment activity is consistent with the underlying principles of SCF. This has included, in a few instances, with some Partners and for some investments, SIB requiring to supplement due diligence activity and strengthen post investment management arrangements. SIB also work in partnership with LINC Scotland, through the ERDF backed Scottish Angel Capital Programme, which supports growth in equity investment by business angels in Scotland while delivering improvements in the capability of these investors.

Partners reported varying regularity of contact with and intensity of input from SIB Portfolio Managers (PMs). The longer established Partners tended to see limited input and attendance at Board meetings between funding rounds, but where issues arose and Partners required PM input all partners considered the PMs to be responsive to requests for information, advice and assistance. Some investors periodically engaged with the PM off-line to cover general issues and to brief them on upcoming issues.

One investor reported that they insist on SIB representation at board meetings as part of their strategy to closely engage SE. Another felt that their investments were more closely scrutinised than others, but nevertheless felt that PMs made a useful contribution and did not cost the business anything.

6.9. Suggested Improvements

Partners were invited to identify any suggestions for potential improvements to the SCF based on their individual perceptions of its current operation. The suggestions were made in the spirit of promoting continuous improvement of the performance of investments and service to both investors and invested businesses. Suggestions from Partners for improved operation of SCF included:

- Reinforcing the principle of investment selection and due diligence by the Partner and investing on *pari passu* terms.
- Giving consideration to raising the SCF investment value ceiling and coincidental deal size thresholds from those currently operating .This would facilitate the supporting of businesses requiring larger initial investments or more follow-on investments.
- Addressing the equity gap above SCF level to help facilitate exits.
- Exploiting networks, including GlobalScot, to improve contact with the financial sector in London and internationally and to promote collaboration with partners in moving business to next stage investment.
- Ensuring proportionality in legal and administrative processes and the resultant costs to SCF Partners which are often borne by invested businesses.

6.10. Summary Findings – Partner Consultations

The findings from our consultations with the SCFII Investment partners can be summarised as follows:

- The principal motivations for Partners becoming involved in SCF were to fund more investments and deliver higher levels of investment in opportunities where this was appropriate. The SCF also provides capacity to share risk, particularly in relation to exposure to follow-on funding needs.

- SCF has increased the number of deals completed in Scotland and resulted in some deals being larger than would otherwise have been the case.

- No Partner reported that they appraised SCF and non-SCF funded business differently and most Partners who have a significant and continuing involvement in the Scottish market will use or consider use of SCF in all eligible investments.

- A number of larger Partners noted the emergence of Enterprise Investment Scheme (EIS) vehicles as a competing source of co-investment.

- Partners report that the deal flow has varied over the evaluation period with a complex interaction of trends reflecting the business cycle and sectoral fashions. No trends in the quality of proposals were noted by sector or geographic area. Although presentation of proposals was considered to have improved, views were mixed on whether the fundamental quality of propositions has actually improved.

- Investments made with SCF support have helped businesses develop technology and products, test market reaction and progress to the next stage of development.

- Both timescale to exit and the number of exits to date has been below Partner expectations. Some investors reported anticipated exits in 5 years (below an historic average of 7-8 years) whilst at present exits are taking close to 10 years.

- Investors are normally represented on the Board of their SCF invested businesses either directly, via an investor member, or through the appointment of a non-executive director. Partners were also providing expertise sometimes directly by the investor or through access to expertise within their membership or network of specialist advisers.

- All 13 investors interviewed continue to believe that the co-investment principle remains relevant. The longer term Partners reported that the co-investment has worked very well and with a high level of mutual trust. However, some Partners held the view that SIB was becoming more selective in follow-on investment, and more engaged in due diligence and management of the investment.

- Partners suggested a wide range of improvements. Beyond refreshing the Partner-led co-investment approach these included: raising the ceiling value for SCF investment; addressing the gap in next round investment above £2m; and using existing SE and SIB networks to stimulate international interest in next-round investment in SCF-invested businesses.

7. SCFII INVESTED BUSINESS FEEDBACK

7.1. Introduction

In this section of the report we provide an analysis of the data and feedback received from the 49 SCFII-invested businesses interviewed in course of the evaluation[21]. Comparison of the sectoral breakdown of the sample to that of the population showed there to be a good match (see 7.2) so that it is felt the sample is representative of the wider population. As previously detailed in the method section, these interviews were conducted through a mix of face-to-face (10) and telephone (39) methods using an agreed question set.

Respondents were all senior managers within the businesses – the majority being at Chief Executive level. The role of our respondents within the businesses is detailed in **Table 7.1.**

Table 7.1: Business Respondent Profile

Role	**No.**	**%**
Chief Executive Officer/Managing Director	32	65%
Finance Director	10	20%
Chief Scientific or Technical Officer/Director	4	8%
Founder	3	6%
Totals	49	100%

Responses were recorded by the Consultants using web-survey software to facilitate analysis.

The following sub-sections present our analysis and interpretation of the findings in relation to:

- Business Profile.
- Sourcing and Application of SCF.
- Effects of SCFII investment on business performance.
- Relative impact of SCFII.
- Relationship with SCFII Partner.
- Relationship with SIB and SE.

[21] A total of 50 business representatives were interviewed. One of these representatives was not in a position to answer our structured consultation as the business was undergoing re-structuring but still wished to provide us with feedback on their SCFII experience.

It should be noted that:

- Opinions we received from the invested businesses on access to equity finance have been included in our market analysis.
- Quantitative business performance data we received from the invested businesses has been used in the calculation of economic impact.

7.2. Invested Business Profile

We asked the businesses about their date of establishment, current employment levels and the SE sector they operated within.

- The businesses varied in age from 82 years to 2 years since establishment. The average age of all the invested businesses in March 2015 was just over 9 years. Removing the outlier value of 82 years reduced the average age to 7.5 years whilst the median value for all invested businesses was 7 years.
- The businesses we consulted employed a total of 860 FTEs at the time of our consultations with average employment of 18 FTEs per invested business. Median employment in the invested businesses was 8 FTEs.

We assigned each of the businesses we consulted to one of the SE growth sectors based on their description of their business and cross checked with SIB data on SCFII investments by sector. There were significant concentrations of SCFII invested businesses within the Life Sciences (33.3%) and Enabling Technologies (31.3%) sectors. This reflects the balance of total investment by SCFII over the evaluation period and was provided for in our sampling of the population of cases. The overall distribution of invested businesses by SE Sector is illustrated in **Figure 7.1**.

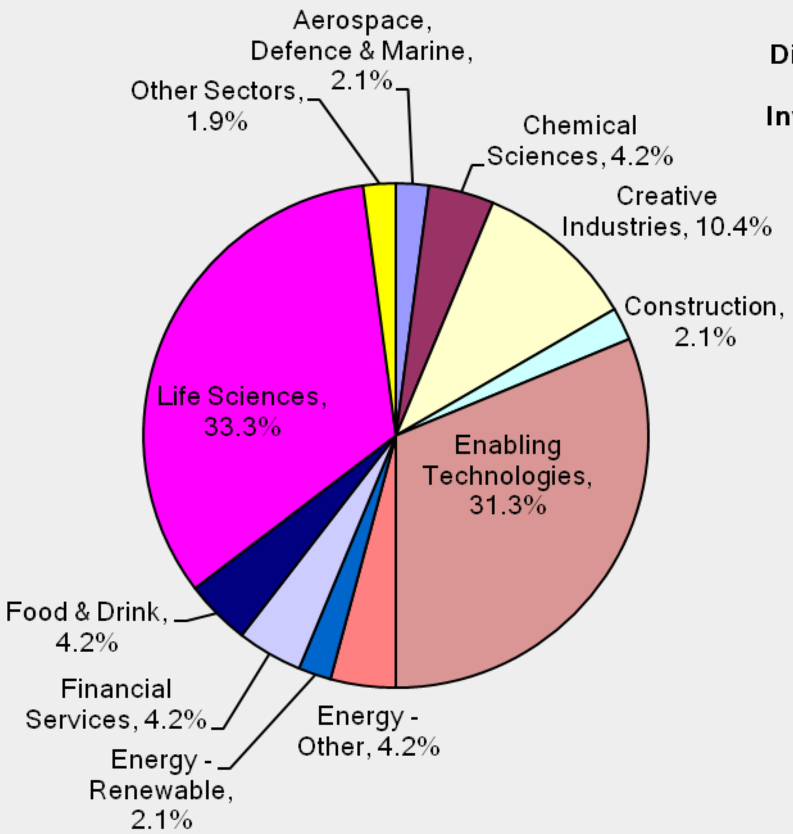


Figure 7.1

Distribution of responding SCF II Invested Businesses by SE Sector

All of the responding businesses were headquartered in Scotland at the time of the consultations in early 2015.

7.3. Sourcing and Application of SCF

We asked each of our consultees how they had become aware of the potential to secure investment through SCFII. The responses we received are detailed in **Table 7.2**.

Table 7.2 : Introduction to SCF as Source of Investment

Source of Awareness	**No.**	**%**
Made approach to SCF Private sector investor	11	22%
SE or HIE Account Manager	7	14%
Accountant or financial advisor	2	4%
Approached by SCF Private sector investor	1	2%
From another funder of the business	0	0%
SE or HIE Website	0	0%
Publicity material - SE or HiE	0	0%
Other	28	57%
Totals	49	100%

Analysis of the "Other" responses received revealed the methods of introduction as:

- Personal and professional knowledge of the corporate finance sector (7 cases)
- Previous investment in the business by SIB (6 cases)
- Had investment in other businesses they were involved in through SIB (6 cases)
- Already had previous investment in the business by the SCFII Partner (4 cases)

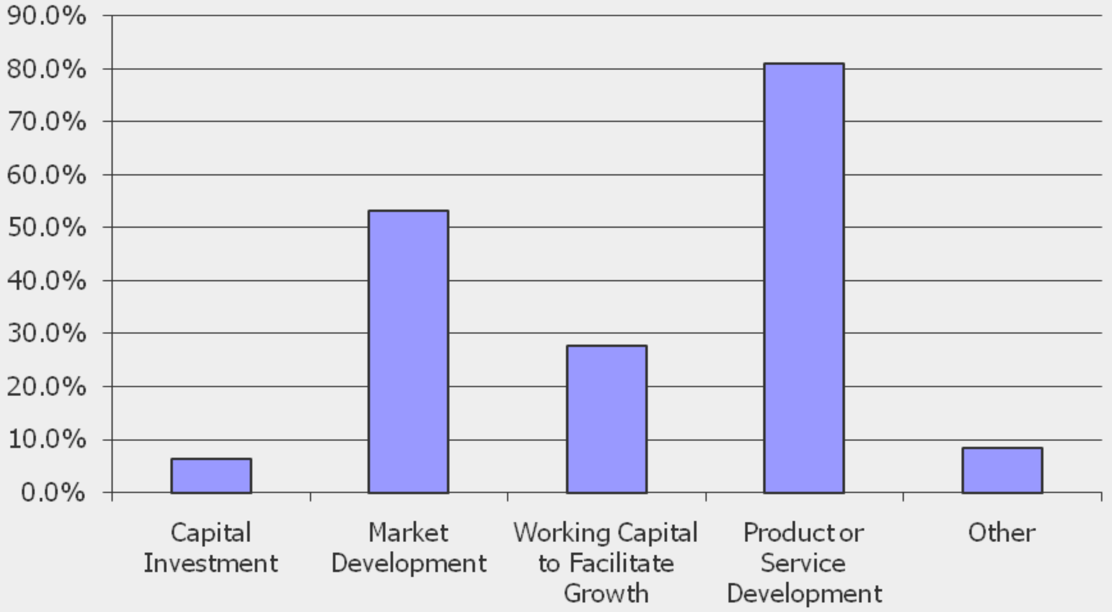
The remaining 5 respondents had not been involved with the business at the start of the SCFII investment process.

We then asked the respondents to identify all of the purposes for which the funding raised through SCFII had been intended (respondents could identify more than one purpose). The responses, set out in **Figure 7.2**, show the range of applications – with the most common being Product or Service Development and Market Development. We further asked about specific purposes for which funding had been required and received a wide range of responses including:

- Proof of Concept
- Product Innovation and Research and Development
- Commercialisation
- Acquisition of a competitor
- Getting Product to market
- Developing Business to a point where it was attractive to VCs

This suggests that SCFII has proved attractive to a wide range of businesses across all stages of development from pure R&D and Proof of Concept through Product development to revenue generation and towards expansion through VC investment and acquisition of competitors.

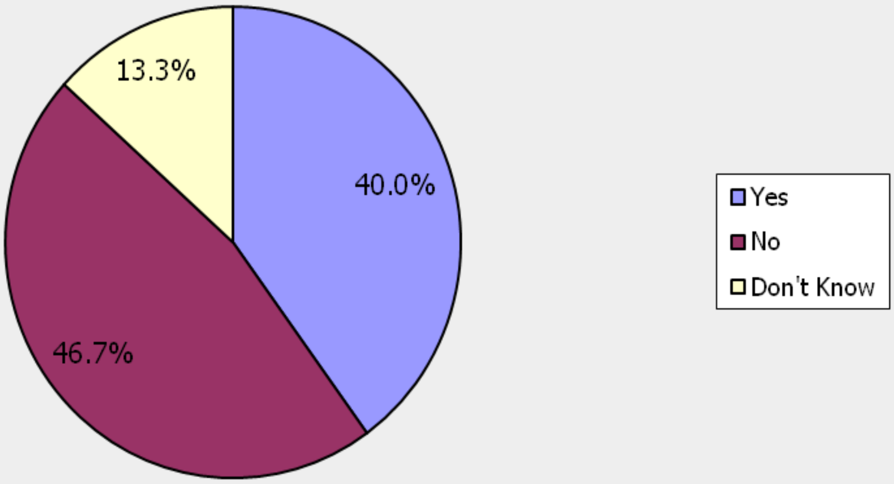
Figure7.2: Proposed Application of SCFII Funding by Businesses



Without exception, the businesses we consulted with confirmed that the SCFII has been broadly applied to the purposes intended at the point of application and first investment.

Next we asked the consultees if they had investigated other potential sources of equity investment and why they had ultimately elected to take up the offer of SCFII funding. The responses are summarised in **Figure 7.3**. The "don't knows" were those who had not been in post at the time the investment application had been made.

Figure 7.3: Businesses confirming investigating other sources of equity funding for the purposes for which they secured SCFII funding.



The majority of those who could respond to this question had not considered other potential sources of equity funding at the point of securing SCFII investment.

The other potential sources of equity finance examined by invested businesses *before* opting for SCFII through their selected Partner, are detailed in **Table 7.3 (overleaf)**

This analysis demonstrates that a significant proportion of our respondents considered more than one SCF Partner before choosing their actual investing partner through SCFII. A smaller proportion did approach VCs and also of note is the one business which had looked at the potential for the emerging option of crowd funding.

Table 7.3: Alternative Sources Of Equity Funding Considered before electing for SCF with Partner		
Potential Alternative Source	**No.**	**%**
Other Angel Syndicates (with SCF)	10	43%
Venture Capital Funds	5	22%
Pre invested HNWIs and Syndicates	3	13%
Scottish Loan Fund (SIB)	1	4%
West of Scotland Loan Fund	1	4%
Corporate Investor	1	4%
Crowd Funding	1	4%
Corporate Finance Advisor (Agent)	1	4%
Totals	23	100%

We then asked those who had considered other sources of equity investment to explain why they had elected to take investment through the SCFII. We received a wide range of responses to our open-ended question, but these have been categorised and summarised in **Table 7.4**.

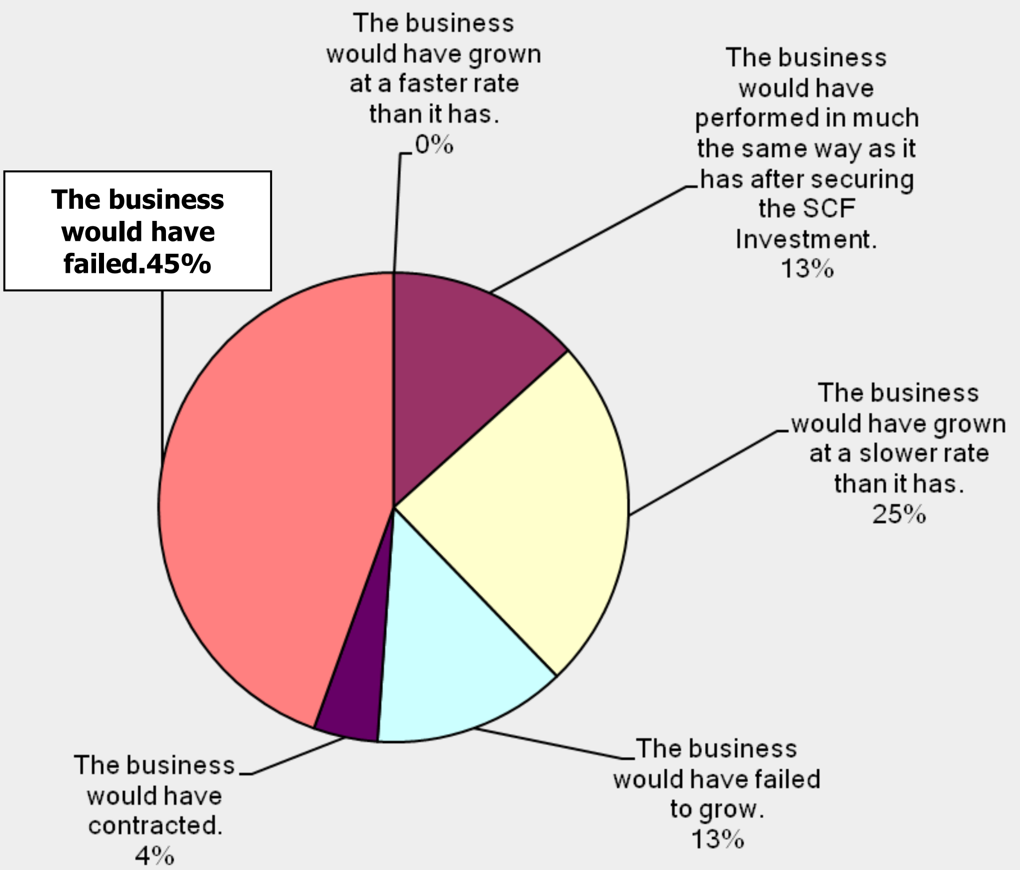
Table 7.4: Reasons cited for Opting to Invest through Partner with SCFII		
Reason	**No.**	**%**
Only Offer of Funding Received	8	24%
Existing relationship with syndicate or individual angel investor	7	21%
Best Offer of funding received (terms and fit with requirements)	5	15%
SCFII part of Package (SCF available from other source)	4	12%
Funding immediately available	4	12%
Best Investor Match (understanding of proposition and potential to add value)	3	9%
Greater Scale of investment available through addition of SCFII	3	9%
Totals	**34**	**100%**

For almost a quarter of our consultees who looked at alternatives, the funding they were offered was the only offer they received. A further 15% considered that the offer received from their preferred SCFII Partner was the best received when considering the terms offered and the fit of the offer with their requirements. Interestingly, for 12% of the respondents the SCF was viewed as an integral part of the funding package regardless of which Partner investor they elected to choose, as all of the alternative investors they had approached were SCF Partners. This suggests that, whilst SCF was important in providing additional scale of investment for these businesses, the relative qualities and experience of the Partner investors were the key determinants in their final investment Partner selection.

7.4. Effect of SCFII on Performance of Business

We asked the consultees what would have been the consequences for their business if they had not secured SCFII investment at the time that they did. Their responses are summarised in **Figure 7.4**.

Figure 7.4: If the funding secured through the SCF had not been available to you at the time it was provided what would have been the likely effect on the performance of the business in the period since?



This analysis shows a significant proportion (45%) of businesses we consulted considered they would have failed if the funding supported through SCFII had not been made available to them at the time it was. Discounting the respondents who considered their business would have performed in much the same way in the absence of SCFII provides evidence to suggest that SCF had a positive effect on 87% of the businesses invested in – by either ensuring survival, preventing contraction or stagnation or allowing them to grow more quickly.

Given that the consideration of the situation which might have prevailed in the absence of SCF is central to identifying additionality we asked for more specific comments from the businesses. A selection of direct quotations relating to failure and slower growth are set out in **Table 7.5**.

Table 7.5: Selected Quotations – Business failing or growth constrained
"No other available source - business was running out of cash."
"Business would simply have disappeared with no funding to progress the product or potential markets."
"Business needed capital to move forward."
"Resources were very low."
"If the SCF funding had not been available the business would have closed down."
"Business would not have got off the ground without SCF."
"Would have struggled to continue to develop product and service. Would have contracted and ultimately folded."
"Would probably have gone to a less ambitious plan and consequently less potential growth."
"Business model was not sustainable. Not saleable and not profitable."
"Growth would have been slower, with associated risks."
"Would have had less resource to work with and would have been trying to secure additional funding sooner."
"Business needed working capital to proceed. We are only 5 individuals and had exhausted available funds."
"Investment necessary to sustain and grow the business - without this the business would not have continued to exist."
"Would have restricted available resources to buy in key staff to develop the service."
"I believe that without SCF, angel investors would have been unlikely to fund this project."
"Business needed £628k to continue and cash flow becoming difficult - no other options for finance available at this time."
"With more limited resources, the process of moving towards commercialisation would have been slower, with all the associated risks."
"I believe the business would have run out of cash before having a marketable proposition."

For those few businesses which considered there would have been little difference in performance if SCFII investment had not been available, the main reasons for this were:

- The SCFII was only a small proportion of the total funding round.
- The SCFII component of the funding round would have been provided by the Partner.

We next asked the business consultees about the performance of their businesses against the projections on performance in place at the time of the SCFII investment.

We have classified their open ended responses into a scalar analysis which is presented in **Table 7.6**.

Less than 10% of the businesses were ahead of projections and just under a quarter were in line with what they had projected. The majority (over 50%) were behind projections and 15% were what we classified as significantly behind – with several of these citing near-failure events or significant changes in the focus or direction of the business as causes. We do not consider this spread of experiences to be uncommon in a portfolio of investments in potential high growth and early stage technology businesses – and in some ways they mirror the proportions of failures, stars and at or below par performing businesses cited by investment partners as typical of their portfolios (and noted in S6.6). Given this, when calculating the impacts of support a 50% optimism bias adjustment has been applied to the gross impacts (see 8.6).

Table 7.6: Business Progress Since Received SCFII

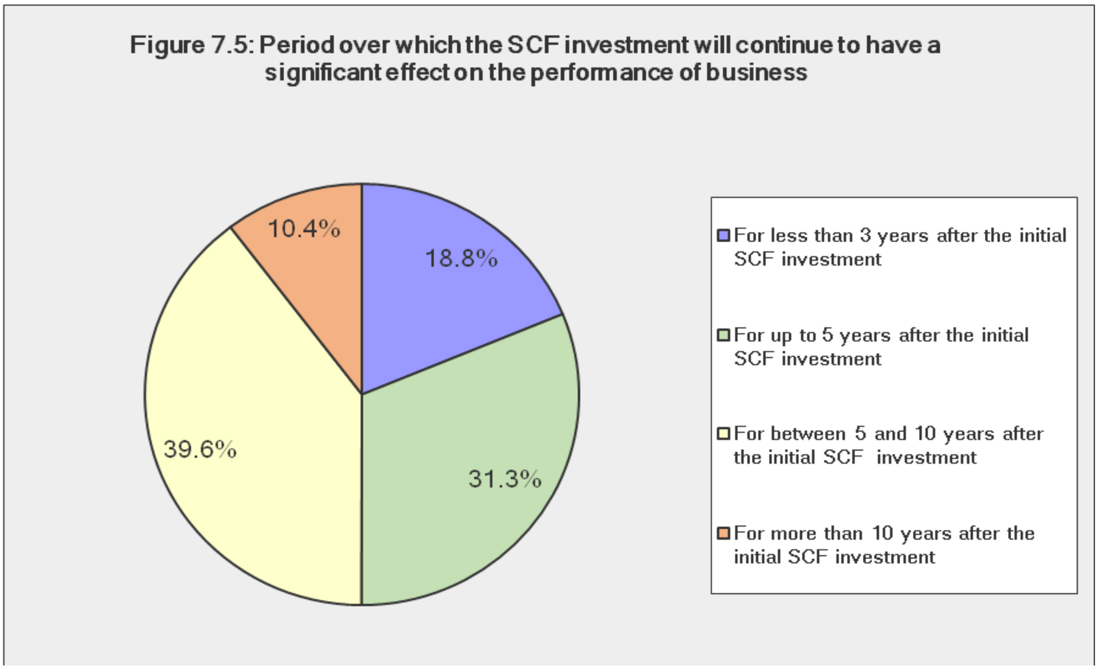
Status at 2015	**No.**	**%**
Ahead of Planned Projections	4	9%
In Line with Planned Projections	11	23%
Behind Planned Projections	25	53%
Significantly Behind Planned Projections	7	15%
Totals	**47**	**100%**

We also asked the businesses if they could make an assessment of the timeframe over which SCF investment would continue to have a positive effect on the performance of their business. The responses we received to an open question split into two camps:

- Those who felt that, because SCF had been essential to the existence of the business, it would have an everlasting effect.

- Those who considered the effect would last only as long as the investment would sustain the development of the business.

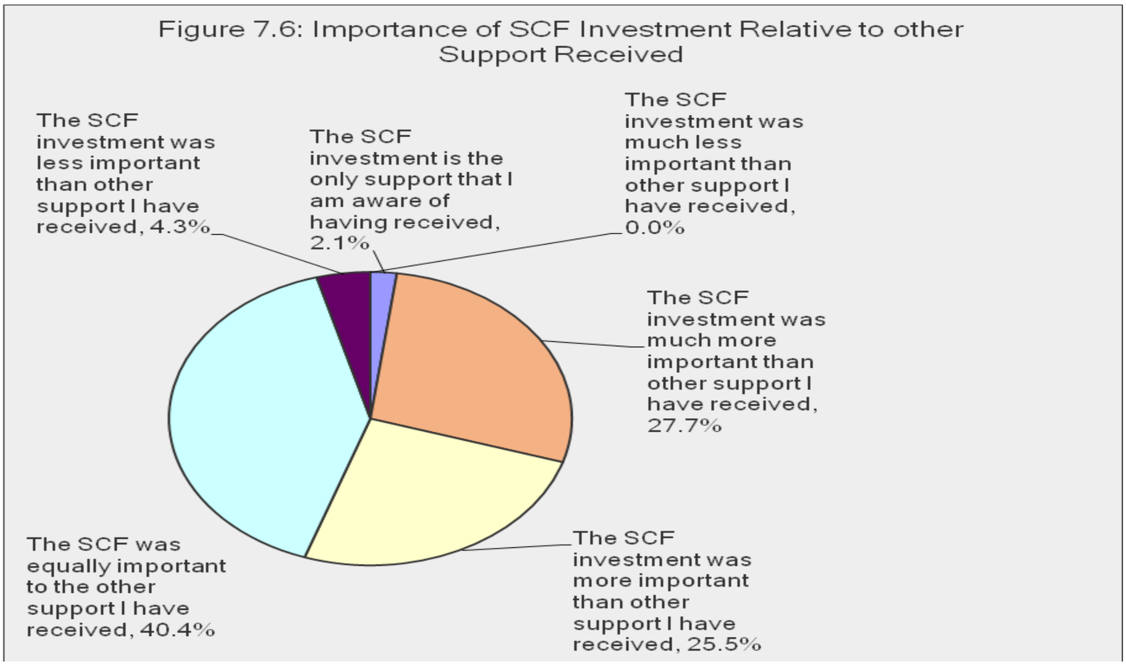
We then asked businesses to assess how long they considered the SCFII investment would continue to have a significant effect on the development of the business. Analysis of the 48 responses we received is presented in **Figure 7.5**.



Exactly half of our respondents considered the effect of the investment would last more than 5 years with 10% considering the effect would last more than 10 years. Just under 20% felt the investment would continue to have an effect for less than 3 years after investment.

7.5. SCFII and Other Support to the Business

We asked each of the business consultees if they could make an assessment of the relative importance of the SCFII investment compared to other support they had received. Their responses, when required to select from a range of options are presented in **Figure 7.6**.



Our analysis of the 47 responses received shows that 40% considered the assistance from SCF to be equally important to other support received. Only 5% considered SCF to be less important than other assistance received, whilst the majority considered SCF to be more or much more important than other support they received to develop their business.

We did ask each of the businesses to elaborate on their assessment of the relative importance of SCFII to other assistance they received. A selection of their responses in relation to those who found it more important and those who found it equally important are set out in **Table 7.7**.

Table 7.7: Selected Quotations – Relative Importance of SCFII to Development of the Invested Business
SCFII Was Equally Important
Part of a mutually supportive programme of assistance to the business.
Have had a range of support to the business which together has got the business to where it is today - impossible to single out one factor or one form of assistance - an holistic process.
Impossible to separate SCF out from the body of support received - have assumed relative levels of importance through time - although without SCF at the time of investment would not have been around to benefit from AM and other support since.
Have had a range of support from SE in the form of pre-regulation and testing support, innovation grants, and international marketing support. All has been critical and has filled gaps as they have emerged. Has effectively topped-up the invested funds and covered costs that would have needed to be found from within the SCF investment funds.
SCFII Was More Important
All investment important in getting business to where it is - but scale of SCF and role in getting to a marketable product and revenue means it is of greater value.
What we do with SCF is truly transformative for the business. What we do with SE helps to de-risk business development and to increase stride at the margin, but is really based on what we would do anyway.
SCF funding has been fundamental, enabling the founders to go full time into working on the project. Other assistance has been important, but hasn't had the same fundamental role. We wouldn't have used the other assistance without having the working capital.
SCF has been of a much greater scale and has played a more strategic role in the development of the business.

On balance, it is apparent that SCFII and other assistance received from SE and SIB are complementary and that many businesses would not have developed as they have without the range of support (including SCFII) they have received. It is also clear that, dependent on the particular circumstances of each business (including the skills of their management team and their access to other advisors) and their specific requirements for capital investment at key stages in their growth, SCFII has been a fundamental requirement for their development.

7.6. Relationship with SCF Partner

We first asked the businesses if they had received support from their SCFII Partner over and above the provision of investment capital. Of the 47 respondents 42 (90%) confirmed that they had received additional input. We received a wide range of specific examples of the types of support received which varied from light touch monitoring to more extensive inputs. The types of support reported included:

- Taking up observer status on Boards.
- Appointment of investor directors from the Partners.
- Appointment of specialist technical NXDs from the Partners or from independent sources.
- Assistance with the selection and appointment of senior management team (SMT) members – including Finance Directors and CEOs.
- Appointment of Board Chairs.
- Assistance with strategy development and provision of a "sounding board" facility.
- Assistance with planning for and securing further funding for the business.

Nearly all of the recipients of this support and advice valued the input and considered that it made a positive contribution to the development of their businesses. One respondent was, however, wary of the involvement of NXDs they did not themselves choose as they might lack the skills and experience relevant to their industries and would add little value.

When asked further about the depth and value of advice provided by Partners it was clear that the extent to which the advice was useful was highly dependent on an alignment of:

- The particular markets and specialist technologies being developed or applied by the invested businesses; and
- The experience and skill set of the Partners and individual investors within their syndicates.

Where this alignment was strong the Partner was more valued as an advisor on technical and strategic direction. In other instances the rigour and discipline brought from monitoring of the investment and the understanding of financing and financial control were more valued by the invested businesses.

There were fewer reported instances of the SCF Partner assisting the SCF-invested businesses with raising additional finance. Here there was less evidence of Partner engagement with 60% of 36 responding businesses saying their Partner had not assisted them in raising additional development finance. For several cases the business had actively adopted this role for itself because the founder or other members of the SMT were highly experienced in accessing corporate finance. Additional sources cited by businesses as having been identified through the Partners have included:

- Non-SCFII matched funding from the SCF Partner.
- Syndication with another investment Partner.

- Introduction of an institutional investor.
- Introduction of a US based Strategic Partner.
- Direct investment and convertible loans from a third party investor.

Several of the businesses also reported they were currently working closely with their investor on developing a funding strategy for their next round of capital investment.

Finally, we asked the invested businesses if there had been any issues in their relationship with their SCF Partner. The majority (60%) reported no issues and a further 10% considered any issues they had to have been within their expectations for a relationship with an equity investor. Of the remaining 30% concerns were expressed over:

- Securing the level of funding considered to be necessary for the development of the business, including the level of match funding from SIB (two cases).
- Differences of opinion over strategy for the next round of investment for the business, with the Partner considered over protective of the angel investors (two cases).
- Delays in getting a release of funds (two cases).
- Concerns over clauses in agreement restricting management discretion to create management positions or offer levels of salaries (two cases) and over scale of legal fees for third parties (equivalent to 10% of equity raised) (one case).

7.7. Relationship with SIB Portfolio Manager

Most SCF-invested businesses have a relatively low-intensity relationship with their SIB Portfolio Managers – reflecting the role of SIB as a co-investing partner through SCFII.

We asked the invested businesses if their SIB Portfolio Manager (PM) had assisted them in developing their business. Of our 47 respondents 13 (28%) considered they had done so. The majority of our respondents identified the PMs as having a purely monitoring function coupled with observer status at Board meetings. In the cases where their role was considered to extend beyond this function they were valued because:

- They provided a signposting and introductory service to allow the business to investigate and access other advice and assistance from SE (including facilitating transition into Account Management of one business).
- Their experience provided insight at Board discussions.
- They liaised with the SCFII Partners and actively engaged in facilitating future funding rounds.

The nature of this relationship and the relatively limited engagement with the PMs over and above investment monitoring is what might be anticipated given:

- The nature of the co-investment model; and
- The fact that many of the invested businesses are Account Managed by SE and have an ongoing business development relationship with an Account Manager.

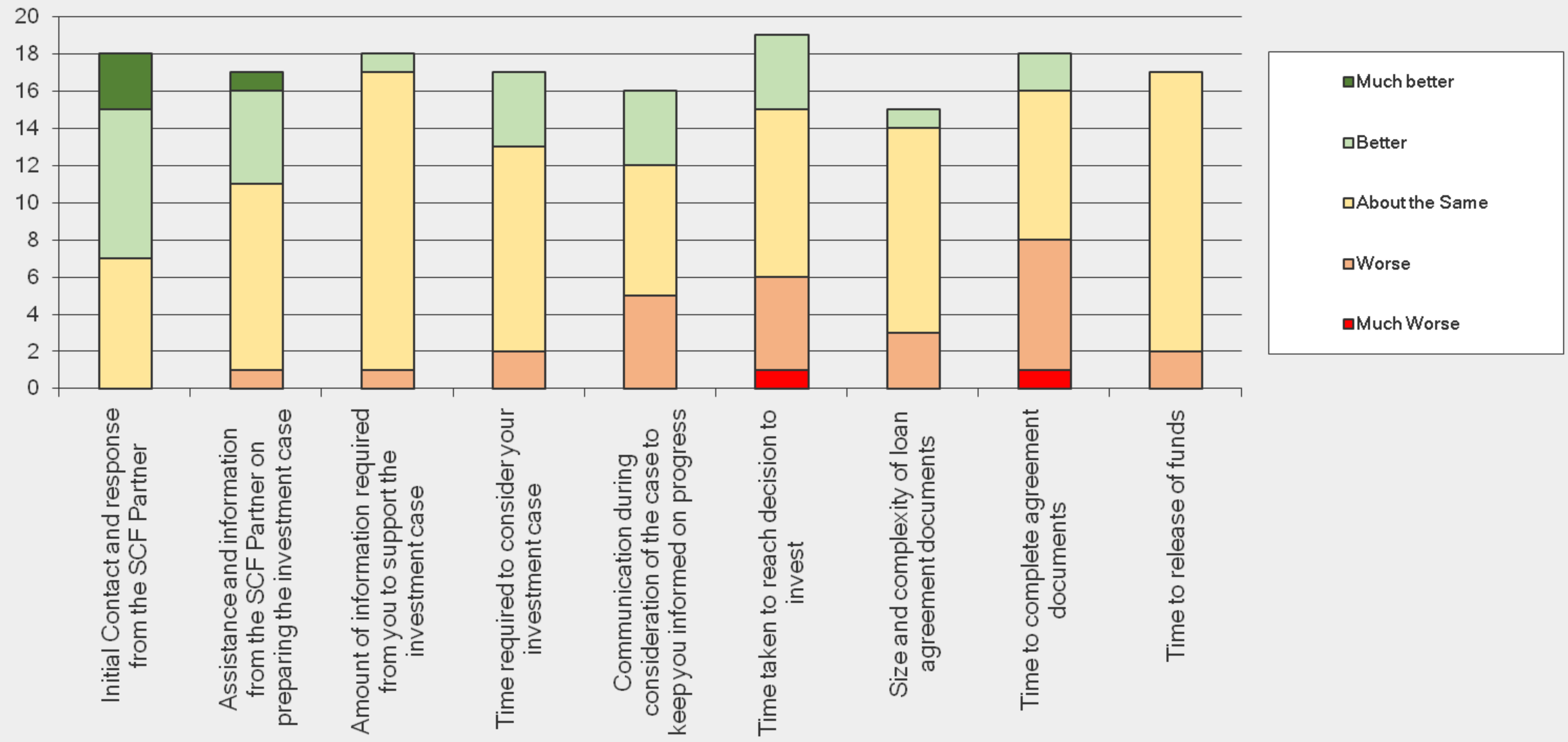
Indeed, when asked if the PM had been a source of advice to the business over 50% of the respondents identified, unprompted, that they considered this to be the function of their Account Manager. Several also stated that the PMs provided a more intensive input to the business at the point of introducing additional finance to the business (either through SCF follow-on or from other sources). Again this was in line with their expectations of the role of the PM.

7.8. SCF Application, Approval and Deal Completion Processes

We asked the businesses to provide an assessment of key aspects of the SCF process from application to release of funds. We asked the businesses to compare key aspects of the process of raising finance through SCF with other sources of finance they had applied for. Because not all of our respondents had recent or relevant experience of applying for other sources of finance we received responses from 20 of our 49 interviewees.

The responses we received are illustrated in **Figure 7.7** and overall suggest that the SCF process is considered to perform similarly to that for other sources of finance. Only in two areas, "time taken to reach decision to invest" and "time taken to complete agreement documents" did higher proportions of interviewees report worse or much worse experience. It should, however, be noted that these administrative functions are undertaken by the SCF Partners as part of the investment process and as such are distinct from the draw-down of SCF by the Partners which is a straightforward and efficient transaction.

Figure 7.7: Relative Assessment of Aspects of SCF Application Process



7.9. Suggested Improvements to SCF

At the conclusion of our interviews we provided the interviewees with an opportunity to suggest any particular improvements to the operation of SCF. Just over a quarter of the interviewees felt there was nothing they could suggest to improve the SCF.

From the remainder we received a range of specific suggestions, from which we have derived a series of common themes. These are:

- Greater recognition of the need for appropriate initial funding which can deliver the aspirations of the business and prevent continuous application of senior management time to serial fund-raising (including follow-on rounds of SCF). Several interviewees considered this could involve SIB ensuring an appropriate scale of investment through SCF at the outset.
- Re-visiting the ceilings for investment through SCF with a view to increasing these; and also reviewing the relationship between investment ceilings of SCF and other SIB funds – particularly SVF.
- Placing greater reliance on the SCF Partner to conduct due-diligence and determine terms and conditions of the investment agreement. Several businesses identified what they considered to be retrenchment from the private sector led co-investment approach with SIB requiring additional or enhanced terms and involving their own legal advisors in deal negotiation.
- Reducing the amount of due-diligence required for follow on investment to reflect initial due diligence conducted at first investment and ongoing Partner involvement with, and SIB monitoring of, the business in the interim period.
- Improving the speed of decision-making and the time from initial application to release of funds.
- A desire for early engagement of PMs, continuity of PM relationship (fewer changes of assigned PMs) and improved communication between PMs and other parts of SE.

7.10. Summary Findings: Business Consultations

The SCF-invested businesses engaged fully with our consultation programme and the findings from their responses can be summarised as follows:

- The invested businesses we consulted had an average age of 9 years in March 2015. The youngest was 2 years old and the oldest had been established for 82 years.
- Around one-third of the businesses we consulted were in the SE Enabling Technologies Sector and similar proportion were categorised as Life Sciences. These proportions are broadly consistent with those in the population of SCFII investment cases over the evaluation period. SCF investment is closely aligned with SE Growth sectors with only 1 of the businesses (2% of the sample) being classified as 'other'.
- Businesses have most commonly applied SCF investment to product or service development and market development – although other applications cited included R&D, proof of concept, innovation and commercialisation.
- Just under half of the businesses had considered other sources of funding and of these over 40% had investigated investment through another SCF Partner with an SCF component to the investment.

- Of those who considered other sources a quarter chose their SCF Partner because they only received an offer of funding from that Partner. Of the others the offer and terms from their SCF Partner had provided the best fit with their requirements, and some opted for their SCF Partner because they had an existing relationship with the Partner or a syndicated member.
- Just under half (44.4%) of businesses we consulted considered they would have failed if the funding supported through SCFII had not been made available to them at the time it was. SCF had a positive effect on 87% of the businesses invested – by either ensuring survival, preventing contraction or stagnation or allowing them to grow more quickly.
- Over 80% of the consulted businesses considered that the SCF investment would continue to have an effect on the performance of their business for three or more years after investment and almost 40% considered the SCF investment to have an effect for between 5 and 10 years.
- Less than 10% of the consultees reported they were ahead of the business performance projections made at the time of investment with just under a quarter were in line with what they had projected. The majority (over 50%) were behind projections and 15% were what we classified as significantly behind.
- The majority of businesses (53%) considered SCF to be more or much more important than other support they received to develop their business and a further 40% considered it equally important to other support received.
- Over 90% of the businesses had received support from their SCF Partner over and above the investment capital. This ranged from placing investor directors or NXDs on their Boards to assistance with selecting Chairman and SMT members through to specific advice on strategy, markets and future financing options. It was clear that the value added by this non-financial support was greatest when the skills and experience of the Partner and their investors were closely aligned with the businesses product or service, markets and technologies.
- Almost three quarters of our respondents had no issues, or only issues they would have anticipated from any other investor, in the course of their relationship with their SCF Partner. Issues highlighted by the remainder included insufficient levels of initial investment, differences of opinion over next rounds of funding and restrictive clauses in agreements.
- Most respondents had a low-intensity relationship with their SIB Portfolio Managers – in line with the role of SIB as a co-investing partner. PM relationships were focused on monitoring the investment and tended to intensify at key points – often related to follow on SCF funding, or a next round of funding. Businesses were not perceived to be seeking a more intensive PM relationship and many saw their SE Account Manager as the primary contact for accessing advice and assistance in developing their business. Several businesses had a more intensive PM relationship and valued their role in signposting and introducing to other sources of business support and networks, actively engaging in next round funding and contribution to strategic decision-making.
- The SCF application, negotiation and completion process is considered to perform similarly to that for other sources of finance. Only in two areas, "time taken to reach decision to invest" and "time taken to complete agreement documents" did significant proportions of interviewees report worse or much worse experience.

- The businesses suggested improvements to the SCF including: more substantial and appropriate levels of initial funding from the Partners and Fund; placing greater reliance on the SCF Partner to conduct due-diligence and determine terms and conditions of the investment agreement; increasing ceiling levels for investment; reducing the amount of due-diligence required for follow on investment; improving speed of decision-making and release of funds; and improving communications between PMs and SE.

8. ECONOMIC IMPACT OF SCF

8.1. Introduction

In this section of the report we present our assessment of the potential economic impact of the investments made through SCFII in the evaluation period (April 2009 to December 2013).

In the following sections we cover:

- The economic impact assessment process and method.
- Data sources used in assessing the economic impact.
- Invested businesses - Markets and Competitors.
- Assumptions and values used in calculating *Net* Economic Impact.
- Aggregate data on levels of deadweight and displacement for the sample of SCFII-invested cases.
- Net Additional GVA Results for the Sample.
- Gross and Net Employment.
- Leverage of Private Sector Investment.

8.2. Economic Impact Assessment Process and Method

It should be noted that our economic impact assessment is based solely on the research we have conducted amongst the invested businesses. This reflects the fact that the evaluation resources were concentrated on the conduct of detailed and quantitative research on the sample of invested cases. Our research amongst the SCF Partners was of necessity more qualitative and contextual and could not provide the opportunity to investigate in detail investment decisions for individual cases.

Our process for calculating the economic impact of SCFII is wholly consistent with the guidance issued by SE Appraisal and Evaluation Team and supplementary advice received from the Team in the course of the evaluation.

Demonstration of a positive economic impact as a result of investment in a business through SCFII is dependent upon:

- Scaling and measuring the extent of the ***additionality*** of the SCFII investment by investigating how the business might have performed in the absence of securing that investment. We have done this by asking the businesses about how they considered their business might have performed if they had not received the SCFII investment at the time they did.

- Assessing the potential for ***displacement*** of economic activity – the reduction in business turnover of Scottish-based competitors of the SCFII-invested business as a result of activity funded by SCFII. We have done this by asking the invested businesses about the locations of their competitors and the dynamics of their main markets – fast growing markets are less likely to generate displacement amongst competitors. It should be noted that we have allowed only for product market displacement. There is some potential for factor market displacement (where the success of one business causes scarcity of an input or increase in costs of an input) but this is outside the scope of our research.

- Reflecting the potential for ***leakage*** where the benefits from any increase in business performance in the SCFII-invested businesses are delivered outside Scotland. In making an assessment of leakage we have asked the businesses we consulted about the proportion of their employees located in Scotland and to confirm their businesses were headquartered in Scotland.

We have also used an economic impact calculator provided to us (prepared by the SE Appraisal and Evaluation team in conjunction with SIB) to arrive at an estimate of the potential economic impact of SCFII. This Excel-based calculator provided only for calculation of Gross Value Added (GVA) and we have therefore enhanced the Excel model to make provision for estimation of gross and net employment.

We have used this amended calculator **for each invested case in our sample** to generate an assessment over three time periods:

- From the evaluation start date in 2009 to the end of 2015.
- For ten years from the evaluation start period to end of 2019.
- For 16 years – from the evaluation start period to a date 10 years from the last possible SCFII investment in 2015 (2025).

The Net additional GVA calculation includes **individual business-specific adjustments for additionality (none, time, or full), displacement and leakage based on consultation responses**. Multiplier effects use business-specific Type II GVA multipliers for the most relevant sector for each business from the most recent Scottish Government tables.[22]

The full model**, incorporating the detailed results of our assessment of economic impact on a case-by-case basis**, has been provided to SIB, subject to restrictions on commercial confidentiality.

8.3. Data Sources used in Assessing Economic Impact

Our assessment of economic impact has been informed from three main sources:

- Responses provided by the sample of SCFII-invested businesses we consulted with in the course of the evaluation research in relation to actual and projected business performance, competitor locations, market dynamics and effects of SCF on business sustainability and growth.

- Analysis by SIB of invested business accounts data held on their database and provided to us, where available on a case-by-case basis.

- Sector-specific data on GVA (where this was not possible to calculate from analysis of the above) from Scottish Annual Business Statistics[23] and on multipliers from the

[22] Scottish Supply Use and Analytical Input-Output Tables, 1998-2011, revised 13th August 2014. http://www.gov.scot/Topics/Statistics/Browse/Economy/Input-Output/Downloads/IO1998-2011L2

[23] Scottish Annual Business Statistics 2012. Released August 2014. http://www.gov.scot/Topics/Statistics/Browse/Business/SABS/SABS-PDF

Scottish Government Input-Output data[24] It is, however, accepted that the nature of some of the investees (for example early stage companies) may mean that the sector specific figures are too high. The application of an optimism bias adjustment is felt to compensate for this. .

The process of assessing actual and projected financial performance of the individual businesses consisted of the following:

- The core data used in assessment of GVA and held by SIB for each business[25] was prepared in advance of consultations.
- In the course of consultation the business was asked to verify any figures provided to us by SIB and any changes recorded.
- The business was also asked to provide projections for the core data over the period for which this existed or could be reasonably estimated. The EIA model provides for application of an optimism bias adjustment to turnover projections provided by the invested businesses, with actual figures excluded from this adjustment.
- Where the business could not verify or project the core data at the time of consultation, a pro-forma data sheet was forwarded to them for population and return.

8.4. Invested Businesses – Markets and Competitors

Where businesses sell their products and services, the rate at which these markets are growing and the locations of competitors are all important determinants of the levels of potential economic contribution. Sales outside Scotland and the UK provide balance of payments benefits and both growing markets and few domestic competitors will reduce the potential for displacement.

In our consultations with businesses we asked them about the proportions, by value, of turnover generated from sales at three geographic levels – Scotland, Rest of UK and Rest of World. **Table 8.1** provides an analysis for those businesses providing a projected turnover figure for 2015. This data excludes one significant outlier with 100% of a large turnover generated outside UK.

Table 8.1: Projected Source of Turnover, by Market: 2015. n=34

Source of Turnover	**% By Value**
Scotland	3.5
Rest of UK	28.4
Rest of World	68.1
Totals	**100.0**

This analysis demonstrates a strong propensity to export outside Scotland and the UK amongst those businesses currently generating a turnover through sales. This suggests these businesses are contributing positively to the UK current account and increasing levels of aggregate demand in the Scottish and UK economies.

[24] Scottish Supply Use and Analytical Input-Output Tables 2014. Op.cit.
[25] Where available this included turnover, profit, employee costs, depreciation and amortisation.

The potential future economic contribution of the SCFII invested businesses is also influenced by the extent to which the markets for their products or services is anticipated to grow. As part of our consultations with the invested business we asked for their assessment of the current levels of market growth. The responses received are detailed in **Table 8.2**.

Table 8.2: SCFII Invested Businesses' Assessment of Market Dynamic for main Product or Service. 2015. n=48	
Market Condition	**% of Respondents**
Declining Rapidly	0.0
Declining	2.1
Static	4.2
Growing	68.7
Growing Rapidly	25.0
Totals	**100.0**

This analysis demonstrates that over 90% of the SCFII-invested businesses are operating in markets which they assess as growing or growing rapidly. This suggests that, subject to maintaining a competitive position in these markets, they have potential to continue to expand. Moreover, they have less potential to displace business and attendant economic benefits amongst any Scottish based competitor businesses, as the growth in the overall market for their product or service can accommodate expansion in all competing businesses.

We also gained an insight into potential for displacement by asking the invested businesses about the number of competitors for their product or service located in Scotland. The responses received are detailed in **Table 8.3**.

Table 8.3: SCFII Invested Businesses' Assessment of Competitors Based in Scotland, 2015. n=48	
Competitor Locations	**% of Respondents**
All the businesses I compete with are based in Scotland	0.0
The majority of the businesses I compete with are based in Scotland	0.0
Around half of the businesses I compete with are based in Scotland	0.0
A minority of the businesses I compete with are based in Scotland	35.4
None of the businesses I compete with are based in Scotland	58.3
I have no direct competitors	6.3
Totals	**100.0**

Once again these results are positive – with over two thirds of businesses stating that they have no competitors based in Scotland (when including those with no direct competitors). None of the businesses had more than 50% of their competitors based in Scotland. This points towards low levels of displacement across the sample of SCFII businesses. The individual responses to this question provided by the businesses are used in our calculation of displacement on a case-by-case basis.

8.5. Assumptions and Values used in Calculating Net Economic Impact.

Assessment of net economic impact requires the gross impacts reported by the businesses to be subjected to the key adjustments described in general terms in **Section 8.2**.

8.5.1. Additionality

In establishing ***additionality*** we explored with each business in consultations the likely effects on the development of their business in the absence of it having secured SCFII investment at the time it did. The responses we received are detailed in **Section 7.4** and **Figure 7.4** of the report. The individual responses of each business have been applied on a case-by-case basis to provide for instances where there was:

- No additionality (the business would have performed in the same way in the absence of SCFII investment).
- Partial additionality (the business would have grown more slowly in the absence of the SCFII investment, the business would have not grown or declined in the absence of the SCFII investment).
- Full additionality (the business would have failed in the absence of the SCFII investment).

The SE/SIB impact model uses ratios of actual and projected turnover with and without SIB investment to determine the levels of additionality.

In cases of **partial additionality** we have therefore adjusted for this in the period after investment by:

- Lagging turnover and projected turnover levels by two years behind levels with SCFII investment to reflect cases where businesses have stated they have grown more quickly than they would have in the absence of SCFII.
- Keeping turnover levels without SCFII investment static where businesses have stated they would have not grown or would have declined in the absence of SCFII investment

In cases of **total additionality** where the business stated it would have failed in the absence of SCFII investment, we have reduced turnover without SCFII to zero in the period after investment.

We have also conducted an analysis of additionality across the Sample by SE sectors, based on the aggregate levels of actual and projected turnover over the evaluation period (2009 to 2025) with and without SCFII. This uses data on turnover with and without SCF as produced by the impact assessment model. The analysis is presented in **Table 8.4**. This demonstrates significant variations in levels of additionality across the sectors from 55% in Life Sciences to 95% in "Other". Overall, additionality across the Sample averages 86%. However, it needs to be stressed, that as with the net impacts, the majority of this turnover growth is projected rather than achieved., with only 20% having been achieved by 2015.

Table 8.4: Aggregate Additionality by Sector Actual and Projected 2009 to 2015 (Sample)			
	T/O with SCF	T/O without SCF	Additionality
Enabling Technologies	£549.0m	£121.0m	78.0%
Life Sciences	£220.6m	£98.4m	55.4%
Other	£1,360.4m	£69.0m	94.9%
Totals	**£2,130.1m**	**£288.4m**	**86.5%**

8.5.2. Displacement

To estimate levels of displacement we interpreted responses form the invested businesses primarily on the location of competitors alongside their projections on the growth rates in their main markets. On the basis of these responses we judged displacement to be nil, low, medium, high or total with attendant values of 0%, 25%, 50%, 75% and 100%.

Again these business-specific responses have been applied on a case-by-case business in the impact assessment model. We have also conducted analysis by value of aggregate levels of displacement across the sample, including separate analysis of the Enabling Technology, Life Sciences and Other SE Sectors. This analysis, conducted by application of the displacement assessment for each case to gross GVA value identified for the case is included in **Table 8.5**.

Table 8.5: Aggregate Displacement by Sector (Sample)			
	Displaced GVA	Gross GVA 2015	Displacement % of Gross GVA
Enabling Technologies	£0.2m	£5.8m	3.3%
Life Sciences	£0.3m	£14.5m	1.9%
Other	£2.1m	£22.4m	9.4%
Totals	**£2.6m**	**£42.7m**	**6.0%**

Aggregate displacement as a proportion of GVA generated in 2015 was assessed at 6% for the sample with significant variation between the sectors, with the level in the "other" sectors being relatively high when compared with the life sciences and Enabling Technology proportions. Overall however, we assess displacement as being low for the sample, reflecting the large proportions of businesses with no Scottish competitors and the extent to which markets for the invested businesses' products and services are reported to be growing.

8.5.3. Leakage

Our assessment of leakage, where business performance and attendant economic benefits are delivered to actors outside the policy area (in this case Scotland), has used responses from the invested businesses on employment levels outside Scotland. We asked for current levels of employment in 2015 outside Scotland. In 2015 of the gross employment in the invested businesses of 868 FTEs, 193 FTEs (22%) were located outside Scotland. These figures were however skewed by two larger invested businesses which, although headquartered in Scotland had significant employment in the US. When these two businesses were excluded the proportion of employees located outside Scotland reduced to 9%.

Again these responses have been interpreted across the invested cases to arrive at nil, low, medium or high levels with attendant values of 0%, 10%, 20% and 30%. The relationship between employment outside Scotland and levels of leakage is not linear as GVA can be generated by the business in Scotland from the activities of employees based outside Scotland – particularly as these employees are often engaged in sales and market development. Moreover, profits and returns to investors (a component of GVA) are often remitted to equity holders based in Scotland – and in the case of SCFII most Partner investors are Scottish-based and comprise syndicates of Scottish HNWIs.

Applying the leakage values adopted for each invested business to the gross GVA estimated to be generated by each in 2015 produces the aggregate assessment for leakage set out in **Table 8.6**.

Table 8.6: Aggregate Leakage by Sector (Sample)

	Leakage of GVA	Gross GVA 2015	Leakage % of Gross GVA
Enabling Technologies	£0.5m	£5.8m	8.4%
Life Sciences	£2.8m	£14.5m	19.6%
Other	£2.1m	£22.4m	9.6%
Totals	**£5.5m**	**£42.7m**	**12.8%**

8.5.4. Persistence of Benefit

The economic impact calculator includes provision for decay of future benefit to reflect the lessening effect on business performance over time from the date of SIB investment. This decay takes effect from the first year after the last projected turnover figure provided by the business in the course of consultation and is applied to the diminishing value of turnover in each subsequent year. The decay rate is set at 20% per annum based on previous practice in applying the model to SIB investments.

The responses we received from businesses when asked to consider the persistence of the effects of the SIB investment were illustrated in **Section 7**, **Figure 7.5**. These responses, whilst useful in gauging the impressions of invested businesses on persistence, were not considered to have the levels of specificity and attribution required to be applied on a case by case basis. The results did suggest a spectrum of opinions, with 40% of businesses expecting the effects to last for more than 5 years from date of investment and 10 % expecting effects to last over 10 years from date of investment.

As only a small number of the businesses consulted provided turnover estimates beyond 2017, and significant proportions provided no projections or one year projections, the majority of cases see decay of effects starting in the period 2016-2018, for SCFII investments made between 2009 and 2013. We consider this to be broadly consistent with the opinions we received in relation to persistence of effects.

8.6. Net Additional GVA for Sample of SCFII Invested Businesses

We have used the economic impact calculator to arrive at an estimate of the potential economic impact of SCFII investment made during the evaluation period of April 2009 to December 2013. This measures impact in the form of **Net additional Gross Value Added (GVA)**.

This assessment has been presented in the report for an aggregation of all of the cases sampled in the Enabling Technologies and Life Sciences Growth Sectors and for those in other SE Growth Sectors and a total for all of the businesses in the sample. The data for each individual business and aggregations for each sector are contained in the Excel model provided to SIB.

It should be noted that:

- **The results have been pro-rated in each case to reflect <u>other</u> SIB investment in the business in the evaluation period. This ensures only that the proportion of benefits relating to SIB SCFII investment are counted in this evaluation. It is accepted that this is a relatively crude approach. It is however an attempt to try to ensure that impacts that might have been driven by other SIB investments are factored out. The alternative would have been to ask the interviewees to apportion impacts to particular tranches of investment. It was felt that this was unlikely to produce any useable responses.**
- **All the benefits relating to investment *facilitated* through SCFII are attributed to SIB rather than being pro-rated to SCF's proportion of the investment. This approach was requested by SE Appraisal and Evaluation to maintain consistency with the assessment method it has previously applied to private sector capital investment.**

It should further be noted that the benefits generated over this period, whilst attributed by the businesses to SCFII, **were delivered whilst the majority of the businesses were in receipt of other assistance and support from SE and SIB**, with over 71% of the population of invested businesses recorded by SE as Account Managed at the commencement of the evaluation (see Section 2.2 for further details of the support received). Whilst other *investment* from SIB has been pro-rated out of the estimates, the less quantifiable but important contribution to these improvements in business performance generated by other assistance from SE and SIB (as reflected in our analysis of responses to the business consultations in **Section 7.5** and **Figure 7.6**) needs to be recognised. SE's wider evidence also suggests that, for most companies, it is the "package" of support that makes the difference to overall performance. Accordingly it may be difficult to disentangle quantitative benefits by support type and this evaluation was specified to explore the specific benefits of SCF support.

The results, for the sample, are presented in **Table 8.7** (for the ***SIB*** **SCFII and Partner investment**). What can be seen is that to date only 20% of the forecast ten year impacts have been achieved and 10% of the sixteen year.

It should be noted that *projected* turnover figures have been subject to a 50% optimism bias adjustment. This is based on the analysis of actual against forecast business performance figures which found more than 50% of the investees were behind in their projections (See 7.4 and Table 7.6). *Actual* figures based on reported data for each business are not subject to an optimism bias adjustment.

Table 8.7: Estimated Net Additional GVA Attributable to SCFII and Partner Investment (Sample)					
		Enabling Technologies Sample	Life Sciences Sample	Other Sectors Sample	All Sample
To date	2009-2015	£10.5m	£14.4m	£6.5m	£31.4m
Ten Years	2009-2019	£64.3m	£32.3m	£56.3m	£152.9m
16 Years*	2009-2025	£182.6m	£36.3m	£71.1m	£290.0m

*The 16 year profile ensures that the impacts of any investments made in 2015 (the end of SCFII) have a 10 year impact profile so that they are comparable to the other investments considered. 1. Subject to Optimism Bias adjustment of 50% on projections. All GVA values are re-based to 2013 prices and discounted to 2009.

8.7. Value for Money Assessment

The Net-additional GVA estimates for SCFII have resulted from SIB investment in the sample of businesses over the evaluation period, rebased to December 2013 prices, of £20.381m.

This investment is a gross figure, representing total SIB funds invested "at risk" and not accounting for returns on investment to date or from future realisations as investment exits are achieved.

Value for Money ratios, based on this value at risk and the SCFII assessment of benefits in Table 8.7 are set out in **Table 8.8**.

Table 8.8: VFM Assessment - SCFII SIB Investment (Sample)

		SCFII GVA (SIB & Partners)	SCF II Investment (SIB)	Benefit to Cost Ratio
To date	2009-2015	£31.4m	£21.3m	1.5:1
Ten Years	2009-2019	£152.9m	£21.3m	7.2:1
16 Years*	2009-2025	£290.0m	£21.3m	13.6:1

* 10 years from end of SCFII period in 2015. 1. Subject to Optimism Bias adjustment of 50% on projections. All GVA values are rebased to 2013 prices and discounted to 2009. 2. At risk value in December 2013 Prices. 3. SCF II Investment figures include an amount for staff costs over the evaluation period. Any additional cost that might be incurred managing the portfolio over the impact period have not been included given the difficulties in estimating these.

It should be noted that these ratios have the potential to significantly improve when, as anticipated, returns on investments made are remitted to the Fund on exits. However, these increases would be offset to some extent if it were possible to accurately cost the other public support provided, particularly through Account Management. It also needs to be recognised that there may be further SE and SIB support before there are Fund exits.

8.8. Grossing-up Net Additional GVA Benefits to Population

The diverse nature of the SCFII population of invested businesses causes us to exercise caution in interpreting any grossing up of the results from our sample of businesses to the population of invested businesses. It is however the case that the sample does closely mirror the population in terms of its sectoral make up (see 7.2) so that the grossed up figures may be broadly indicative of the population.

For the purposes of illustrating a potential economic benefit yield (expressed as Net Additional GVA per £ of SCFII invested by SIB) from the investment of SCFII to date we have set out in **Table 8.9** a projection of benefit based on investment value for the population of cases in each the Life Sciences, Enabling Technologies and Other sectors, and our results for the samples in each of these sectors.

Table 8.9: Illustrative Grossing Up of Economic Yield to SCF Population of Investments					
		SCFII GVA (SIB & Partner) Sample	SCF II Investment (SIB) Sample [1]	SCF II Investment (SIB) Population [1]	Illustrative SCFII GVA (SIB) Population
Enabling Technologies					
To date	2009-2015	£10.5m	£7.0m	£17.0m	£25.4m
Ten Years	2009-2019	£64.3m			£156.4m
16 Years*	2009-2025	£182.6m			£444.3m
Life Sciences					
To date	2009-2015	£14.4m	£3.9m	£13.6m	£50.4m
Ten Years	2009-2019	£32.3m			£113.3m
16 Years*	2009-2025	£36.3m			£127.4m
Other SE Key Sectors					
To date	2009-2015	£6.5m	£7.1m	£15.0m	£13.8m
Ten Years	2009-2019	£56.3m			£119.3m
16 Years*	2009-2025	£71.1m			£150.7m
All Cases					
To date	2009-2015	£31.4m	£17.9m	£45.5m	£89.7m
Ten Years	2009-2019	£152.9m			£389.0m
16 Years*	2009-2025	£290.0m			£722.3m

1. Money values – not re-based.

8.9. Assessment of Potential Employment Benefits

By enhancing the economic impact assessment calculator devised by SE and SIB we have provided for estimation of Gross and Net Additional FTE employment in the sample of SCFII-invested businesses. This analysis is informed through the consultation programme where businesses were asked to provide details of current employment and, where available, projections of future employment.

Not all businesses were in a position to forecast future employment, and others provided projections for different time periods. The majority of businesses provided projections to 2017 or 2018 and a minority projected employment to 2020. No business projected employment beyond 2020. Consequently we have elected to present peak employment over the evaluation period after 2015 which is likely to be an under-estimate of actual future employment.

Employment data has been subject to the same pro-rata apportionment to other SE/SIB investment and SIB/Partner investment in the evaluation period as detailed in **Section 8.6**. In assessing the Net Additional Employment we have used the same assumptions as used for additionality, displacement, leakage and multiplier effects (as detailed in **Section 8.5**) on a case-by-case basis. Given the preceding comments on the potential under-estimation of employment benefits beyond 2015 we have not applied optimism bias adjustments to the employment projections. The results for 2015 and Peak, Gross and Net Additional FTEs are detailed in **Table 8.10**.

Table 8.10: Gross and Net Additional Employment Attributable to SCFII[1] (Sample rounded to the nearest ten))

	FTE Employees 2015		Peak[2] FTE Employees to 2025	
SE Sector	Gross	Net Additional	Gross	Net Additional
Enabling Technologies	250	70	490	160
Life Sciences	250	60	420	80
Other	370	110	560	420
Totals	**870**	**240**	**1470**	**660**

1. (SIB and SCF Partner Investment)
2. Peak Employment is highest projection provided by each business in period to 2025. Not all businesses could provide employment projections so for some 2015 employment level will be recorded as peak.

8.10. Leverage of Private Sector Investment

Our previous analysis in **Section 5** of data on investment activity through SCFII provided by SIB, included in **Table 5.2** an analysis, by SE sector, of the relative values of SIB and SCFII Partner investment. This demonstrated an average SCFII intensity of 38% of total investment compares to a high of 47% in the Energy (other) sector, 44% in the Renewable Energy and Food and Drink sectors and the lowest level of 26% in the Financial Services sector. Over the evaluation period total SCFII investment of £45.5m was matched by SCFII Partner investment of £74.6m. Across all investments made through SCFII over the evaluation period these figures translate into a private to public sector leverage ratio of 1.64:1.

9. PERFORMANCE AGAINST ERDF OBJECTIVES & OUTCOMES

9.1. Introduction

In this section of the report we re-visit the ERDF application for the SCF and compare results for the evaluation period with the original objectives and targets for physical and financial progress set out in the application.

9.2. ERDF Application Objectives

The full ERDF application form identifies the specific objective of the proposed SCFII as being:

to address the early stage equity gap for ambitious young growth companies by: increasing the money supply available to investors and companies seeking risk capital support; and introducing new investors from outwith Scotland.

The objectives were to be achieved by:

- recapitalising the Scottish Co-investment Fund, established as an evergreen fund with ERDF support in 2003 to operate throughout the period 2008-15.
- investing up to £1million in small and medium sized companies, and in particular micro and small enterprises, with high growth potential.
- investing on a pari passu basis with SCF Partners within a deal ceiling of £2 million.
- investing in businesses throughout Scotland (although only businesses in Lowlands and Uplands Scotland were eligible for ERDF support).

The application cites evidence of an early stage equity gap at an EU, UK and Scottish level[26], including from previous evaluation[27] which included surveys of SCF-invested companies and the financial sector. It points to further evidence in the form of take-up of existing provision and how SCF had become involved in more than half of recorded deals by 2004[28].

Significantly, the application makes clear that the established pattern of investment involved SCF Partners following their money in invested companies over several rounds until achieving an exit approximately 7 years later.

9.3. Progress against ERDF Application Objectives and Targets

We have been provided with an ERDF Progress Report by SIB which covers the period to March 2013[29]. The Outputs, Results and Targets table from Part 2 of the Progress Report is reproduced as **Table 9.1**. On the basis of this Progress Report and achievement of

[26] EC, 2006, Guide to Risk Capital Financing in Regional Policy; HM Treasury, 2003, Bridging the Finance Gap; Scottish Government, 2004, Framework for Economic Development in Scotland.
[27] CSES, 2007, Evaluation of ERDF Supported VC and Loan Funds in Scotland and the SCF.
[28] Don and Harrison, 2006, The Equity Risk Capital Market for Young Companies in Scotland 2000-4.
[29] EUROSYS - Progress Report for Period Number 17 for Application LUPS/ERDF/2008/1/2/0194. (Electronic version unsigned).

Table 9.1: Claim Form Data Reproduced From ERDF Progress Report to End March 2013						
Type	**Indicator**	**Target from Application**	**Total from Previous Progress Reports**	**Actual (This Progress Report Only)**	**Current Total**	**% Completed**
Output	No. of Enterprises Receiving Financial Support	128	116	5	121	95%
Output	No. of Individuals and New Enterprises receiving advice/consultancy	0	0	0	0	0%
Output	No. of Enterprises Receiving Support for E-commerce	60	0	0	0	0%
Output	No. of Enterprises Receiving Support for Energy Saving and Resource Efficiency	40	0	0	0	0%
Result	Increase in Turnover in Supported Enterprises (£mn)	128	0	0	0	0%
Result	No. of New Business Starts Resulting from Support	32	0	0	0	0%
Result	No. of E-commerce Strategies Developed	40	0	0	0	0%
Result	No. of enterprises implementing environmental audits and energy-saving/resource efficiency systems	32	0	0	0	0%
Result	No. of Gross Jobs Created	896	0	0	0	0%

95.4% of the Primary Output Measure (number of enterprises receiving financial support) a claim was made to draw down the balance of ERDF contribution to SCFII.

Data from our evaluation research shows a total fund expenditure by December 2013 of £45.5m which is consistent with the figure of £43.8m to April 2013 provided in the Progress Report. Our analysis of data provided by SIB shows a total of 139 businesses invested in through SCFII to December 2013 which is again consistent with the 121 businesses reported as being provided with financial support for the period included in the Progress Report.

We have reported (in **Table 8.10)** a gross current (2015) employment figure of 195 FTEs for our sample of businesses. Grossing this up to the population of businesses is problematical for the reasons cited in **Section 8.8**. For illustrative purposes we have applied the grossing up ratio used for GVA to FTE employment in the sample. This produces an estimate of 496 employees for the population in 2015, rising to a peak employment figure in the period to 2025[30] of 1,212 Gross FTEs.

This leads us to conclude that the gross employment target identified in the ERDF Result target (896 FTEs) is likely to be exceeded by the end of 2015. There is also a high probability, based on employment projections provided by our sample of businesses, of the gross employment associated with the SCFII, increasing to well beyond the target set out in the 2008 ERDF application by 2017. This is a strong performance, particularly given the repercussions of the Global Financial Crisis, the extent of which were unforeseen at the time of the application in 2008.

[30] As noted in Section 8.9 – no business projected employment beyond 2020 and the majority did not project beyond 2017. 2025 is used as an end-point here because it is 10 years from the end of SCFII in December 2015.

10. CONCLUSIONS AND RECOMMENDATIONS

10.1. Introduction

In this last section of the report we draw on the findings of the evaluation research to conclude on the evaluation objectives set out in the brief and re-stated in **Section 2.2**.

In presenting our conclusions we have elected to first address the specific evaluation objectives (SEOs), reproduced below.

- The extent to which the original rationale for SCF is still valid and, if this is no longer the case, to explain why and how this rationale has changed.
- The commercial performance of the Fund based on the number of investments to date, their value, losses and exits.
- The impact of SCF on the capital market in Scotland including the impact on the co-investees.
- The effectiveness of the SCF delivery arrangements, including the role of the SCF partners and evidence of value added, post investment management arrangements, and areas for enhancement.

We then proceed to conclude on the overall evaluation objective (OEO) of assessing:

- The impact that support through SCF has had upon the growth of the investee companies; and
- The extent to which SCF funding and support complements other support provided through SE.

Finally we comment further on the potential economic impact of SCFII – which, whilst not explicit in the evaluation objectives, was implied from the overall objective and the method proposed by us for the evaluation. The start is, however, to look at the evidence as to "what works" in driving impacts in the investees.

10.2. What Works in Driving Impacts?

The various interviews, with the partners and investee companies, have enabled some broad conclusions to be drawn as to what drives economic impacts. The key is the Fund's ability to provide finance when the company needed it, given that almost half of the companies stated that the business would have failed without SCF investment (Figure 7.4). Within this context the key things that seemed to be related to impacts were:-

- The appointment of board members with relevant skills and expertise;
- The investors exploiting the links they have with networks and other specialists to the benefit of the investee;
- Other complementary support and advice received through SE; and
- The role of the portfolio manager in acting as a signpost to other advice and support from SE. Where businesses were Account Managed the Account Manager (and the Account Team including the Portfolio Manager) fulfilled this role.

SEO 1: Assess the extent to which the original rationale for SCF is still valid and, if this is no longer the case, to explain why and how this rationale has changed.	
Conclusion	**Reference (Report Sections)**
We re-visited the original rationale for SCF and summarised this as being based on risk aversion, transaction costs and lack of investor capacity and capability in the Scottish equity funding sector. **Overall we conclude that the rationale for intervention through SCFII remains valid based on our findings as referenced below.**	S3.2 S3.3
Securing of **equity finance for young pre-revenue businesses** in Scotland **remains challenging** as evidenced by the conclusions of our business survey. Access was most difficult for businesses in the Life Sciences, Technology, Engineering and Creative Industries sectors. Businesses in the Seed and Growth stages were considered to have most difficulties in accessing necessary funding. Finance in the deal ranges £500k to £1m and £2m to £5m ranges are considered most difficult to secure.	S4.4 S4.5
All investors interviewed are of the view that SCF is addressing a **valid ongoing and structural market failure** in the supply of risk capital for start-up and early stage businesses. In the absence of SCF in Scotland there would be a **significant shortfall in supply** at this level.	S4.6
There is a strong **public policy rationale** for intervention in providing **equity** investment for young, potentially high growth and **innovative pre-revenue businesses** which would struggle or fail to secure this in the absence of fiscal incentives to private investors (EIS and SEIS) and match funding from public sector MEIP funds (including SCF).	S4.2
Evidence from Scotland showing that **Angel Syndicates**, and **matching SCF**, represent a **significant proportion** (35%) of the total **private equity investment in small businesses within Scotland**. Angels provide the majority of investment (87% by value in 2014) in the £100k to £2m deal space with some evidence of a muted return of VCs to this space in 2014. This suggests that any SCF withdrawal or retrenchment from this market would have significant and damaging consequences on the availability of equity funding for these businesses.	S4.3.2 S4.5

SEO 2: Assess the commercial performance of the Fund (SCFII) based on the number of investments to date, their value, losses and exits	
Conclusion	**Reference (Report Sections)**
We conducted an in-depth analysis of raw data on SCFII provided to us by SIB, based on interrogation of their IMRS database and the SCFII Fund Accounts. **Overall, we consider that, given investments through SCFII over our 2009-2013 evaluation period were anticipated in the Fund Business Plan and ERDF application to be exiting, on average, 7 years after investment, (i.e. 2016 to 2020), it is too early to draw substantive conclusions on performance of the Fund. This is compounded by evidence from investor consultations suggesting that exits are taking longer to achieve than anticipated with expectations that these may take over 10 years.**	S5.2 – S5.5 S9.2 S6.6
Over the evaluation period the SCFII has invested in a total of **139 Businesses**. **SCFII investment** in these businesses has totalled **£45.5m** and levered private sector SCFII **Partner investment of £74.6m**. These figures translate into a private to public sector leverage ratio of 1.64:1.	S9.3 S8.10
Year-on-year, over the evaluation period, **increasing proportions** of total fund investment have been taken up by **follow-on deals**. In 2009 SCFII follow-on deals represented 11% of total SCFII investment to the end of that year with this proportion rising to just over 40% of total SCFII investment to the end of 2013.	S5.5
Partners expectations on likely out-turns of their investment suggest that typically, out of ten investments: 1 will sell with a high multiple; 1 will sell with a modest multiple; 3-4 will recoup the investment; and 4-5 will fail. In terms of performance of the SCFII-supported businesses, Partners do not report that their experience, in terms of failures, is outside their expectations and some are bullish about the prospects for good returns.	S6.6
Using data provided by SIB, our analysis shows the proportion of **SCFII investment written off** is running at a rate of **4.2%** of SIB investment to the end of FY 2013. **Income received** over the same period is equivalent to **7.7%** of SIB investment made through SCF to the end of FY 2012/13.	S5.6

SEO 3: Assess the impact of SCF on the capital market in Scotland including the impact on the co-investees.	
Conclusion	**Reference (Report Sections)**
We reviewed evidence on the extent of angel investment in Scotland and conducted consultations with 13 SCFII Investment Partners. **Overall, we conclude that, over the evaluation period, SCFII has represented a significant proportion of the risk capital market in Scotland in the sub £2m deal space.**	S4.3.2 S4.4
Evidence from Scotland showing that **Angel Syndicates**, and **matching SCF**, represent a **significant proportion** (35%) of the total **private equity investment in small businesses within Scotland**. Angels provide the majority of investment (87% by value in 2014) in the £100k to £2m deal space.	S4.3.2
Year-on-year, over the evaluation period, **increasing proportions** of total fund investment have been taken up by **follow-on deals**. In 2009 SCFII follow-on deals represented 11% of total SCFII investment to the end of that year with this proportion rising to just over 40% of total SCFII investment to the end of 2013.	S5.5
Investment in the **SCFII deal-space** (£100k to £2m) in Scotland in **2012 and 2013** is estimated at **£82.5m**. Total deal value of **SCFII funded investments** in this same period was **£39.5m or 48%** of the total estimated value. Of this £39.5m **SIB investment through SCFII accounted for £14.2m or 17% of the total** estimated value of the SCFII deal-space market in this period.	S4.3.2 (Figure 4.5) 5.2 (Table 5.1)
Partners report SCF has **increased the number of deals** they completed in Scotland. One angel investor noted that SCF enabled some deals to go ahead where otherwise there would have been insufficient interest from their members. SCF has also resulted in some **deals being larger than would otherwise have been the case**, providing resources to make a step change or extending the period to next funding round. These positive effects on number and size of deals mean that **the total volume of investment has increased**.	S6.4

SEO 4: Assess the effectiveness of the SCF delivery arrangements, including the role of the SCF partners and evidence of value added, post investment management arrangements, and areas for enhancement.	
Conclusion	**Reference (Report Sections)**
In our consultations with 49 SCFII-invested businesses, 13 SCFII Investment Partners and Stakeholders we explored a range of aspects of the delivery of SCFII. **Overall, we conclude that, the delivery arrangements have worked satisfactorily for all of the parties with some noted exceptions in individual cases.**	S6 S7
Almost three quarters of business consultees had no issues, or only issues they would have anticipated from any other investor, in the course of their relationship with their SCFII Partner. The SCFII application, negotiation and completion process is considered to perform similarly to that for other sources of finance.	S7.6 S7.8
Most business consultees had a low-intensity relationship with their SIB Portfolio Managers – in line with the role of SIB as a co-investing partner. PM relationships were focused on monitoring the investment and tended to intensify at key points – often related to follow on SCF funding, or a next round of funding. Businesses were not perceived to be seeking a more intensive PM relationship.	S7.7
Over 90% of the businesses had received support from their SCF Partner over and above the investment capital. This ranged from placing investor directors or NXDs on their Boards to assistance with selecting Chairman and SMT members through to specific advice on strategy, markets and future financing options. It was clear that the value added by this non-financial support was greatest when the skills and experience of the Partner and their investors were closely aligned with the businesses product or service, markets and technologies.	S7.6
Partners reported varying experience in terms of the regularity of contact with, and intensity of input from, SIB Portfolio Managers (PMs). The longer established Partners tended to see limited input and attendance at Board meetings between funding rounds, but where issues arose and Partners required PM input all partners considered the PMs to be responsive to requests for information, advice and assistance.	S6.8
The longer term Partners reported that the co-investment has worked very well and with a high level of mutual trust. However, some Partners suggest that the co-investment principle has become eroded over time with SIB becoming more selective in follow-on investment, engaging in due diligence and becoming more involved in management of the investment.	S6.8

OEO A: Assess The impact that support through SCF has had upon the growth of the investee companies	
Conclusion	**Reference (Report Sections)**
In our consultations with the 49 SCFII-invested businesses and 13 SCFII Investment Partners we explored the impact the SCFII investment has had on the businesses. **Overall, we conclude that, the SCFII investment received by the businesses we consulted has been instrumental in sustaining and progressing their growth. It has done this primarily by providing equity finance to those businesses at points where they would not secure debt or VC funding because of their risk profile, time to revenue generation and scale of finance required.**	S6 S7 S4.2
87% of Business consultees reported that their SCIIF investment had a **positive effect on their business** – by either ensuring survival, preventing contraction or stagnation or allowing them to grow more quickly.	S7.4
Using the data on net additionality from our consultations, we have assessed **aggregate actual and projected turnover of the businesses in our sample** over the evaluation period. This demonstrates aggregate turnover **with SCFII of £2,130Mn** and **without SCFII of £288Mn** – indicating that businesses in our sample are associating actual and projected turnover of £1,840Mn with their SCFII investment. However, it needs to be stressed that only a proportion of this turnover has been achieved to date (20% for the 16 year impact profile).	S8.51 Table 8.4
The projections made by our sample on turnover need to be tempered by their responses on **current performance against past projections**. **Less than 10% of the businesses were ahead of projections** and just under a quarter were in line with what they had projected. **The majority (over 50%) were behind projections and 15% were what we classified as significantly behind** – with several of these citing near-failure events or significant changes in the focus or direction of the business.	S7.4 Table 7.6
Partners see the investment made in businesses with SCF support as having enabled them to **develop technology and products, to test market reaction** and, where gaining traction, to **progress to the next stage of development.**	S6.6

OEO B: Assess the extent to which SCF funding and support complements other support provided through SE.	
Conclusion	**Reference**
The evaluation brief and inception process were clear in identifying the complementary role of SIB investment in SCFII, to other SE and SIB investment and support provided to the SCFII-invested business. In particular over 70% of the population of SCFII invested businesses over the evaluation period were recorded by SE as Account managed at the start of the evaluation. A decision was made at evaluation inception to pro-rate benefits against other SIB investment identified as having been made in the evaluation period. It was not considered possible to pro-rate Account Management and other non-financial assistance in this way, with these effects being addressed through qualitative assessment in business consultations. **Overall, we conclude that, whilst SCFII investment *per se* is an important contributor to the growth of the invested business (and often cited by businesses as the most important), it is the combination of investment <u>and</u> support to the businesses' SMTs provided by the SCF Partners, SE Account Managers and the other SE/SIB support that they can lever, SIB Portfolio Managers (and the NXDs and other advisors identified by them), that together provide the best conditions for optimal growth and success.**	S8.6
40% of Business consultees considered the assistance from SCFII to be equally important to other support received. Only **5% considered SCF to be less important** than other assistance received, whilst **the majority considered SCF to be more or much more important than other support** they received.	S7.5
We asked each business to elaborate on their assessment of the relative importance of SCFII to other assistance they received. From their responses it was apparent **that SCFII and other assistance received from SE and SIB are complementary and that many businesses would not have developed as they have without the range of support (including SCFII) they have received**. It was also clear that, **dependent on the particular circumstances of each business** (including the skills of their management team and their access to other advisors) and their specific requirements for capital investment at key stages in their growth, **SCFII has been a fundamental requirement for their development**.	S7.5
When invested businesses were asked if their SIB Portfolio Manager had assisted them in developing their business, 28% considered they had done so. Over 90% of the businesses had received support from their SCF Partner over and above the investment capital. This ranged from placing NXDs on their Boards to assistance with selecting Chairman and SMT members through to specific advice on strategy, markets and future financing options.	S7.6 S7.7
A majority of businesses identified, unprompted, the role of the Account Manager as their primary source of advice.	S7.7

OEO C: Assess the economic impact of SCFII	
Conclusion	**Reference (Report Sections)**
Overall, we conclude that, SCFII has the potential to generate significant economic impact at the Scottish and UK levels. This is based on the identification, amongst our sample of: ▪ **High levels of additionality based on consequences for the businesses of not receiving SCFII investment at the time they did.** ▪ **Minimal displacement due to low levels of domestic competition and strong growth in target markets.** ▪ **Strong actual and projected export performance.**	S8.6
87% of Business consultees reported that their SCFII investment had a **positive effect on their business** – by either ensuring survival, preventing contraction or stagnation or allowing them to grow more quickly.	S7.4 S8.5.1
Displacement (at 6%) is assessed as being low for the sample of invested businesses, reflecting the large proportions of businesses with no Scottish competitors and the extent to which markets for the invested businesses' products and services are reported to be growing.	S8.5.2
Over 90% of the SCFII-invested businesses are operating in **markets** which they assess as **growing or growing rapidly**. Across our sample businesses currently generating a turnover through sales identified 83% of actual or projected turnover as coming from outside Scotland and the UK. This suggests these businesses are contributing positively to the UK current account and increasing levels of aggregate demand in the Scottish and UK economies.	S8.4 Tables 8.1 &8.2
To date (2015) SCFII invested businesses in our sample are estimated as having generated £31.4Mn of Net Additional GVA (NAGVA) from SIB and Partner Investment, Projected NAGVA to 2025 is estimated on this same basis at £290Mn. Value for Money ratios for the sample investment value of £21.3m (SIB only including staff costs) are: 1.5:1 in 2015 rising potentially to 14:1 in 2025. These ratios use the assessed NAGVA from combined SIB & Partner SCFII investment and the cost of SIB investment only – as specified by SE Appraisal and Evaluation. These ratios are based on at risk SIB investment values and will underestimate VFM because they assume that no funds will be returned to SIB or on exits from SCFII investment. Net Additional employment in the sample businesses is estimated at 240 FTEs in 2015, rising to a projected peak of 660 FTEs by 2025..	S8.6 Table 8.7 Table 8.8 Table 8.10

9.3 Recommendations

Based on our research and conclusions we provide the following recommendations on the SCF.

- The SCF should continue to operate as a Partner-led Co-investment investment fund on the MEIP addressing structural issues in the equity (risk) capital market in Scotland.
- SCF investment should continue to be delivered in a context where co-ordinated support, advice and potential future investment from SCF Partners, SIB and SE is understood to be not only complementary but essential to optimising the growth of the SCF-invested businesses.
- Delivery of economic impacts from SCFII depends on securing exits from investments. Whilst exits have taken longer to achieve than originally anticipated, the Partners and SIB need to continue to work to accelerate and secure successful exits and to take appropriate action where exits appear unlikely. Where exits are achieved which generate a surplus or wholly or partially return invested funds, they have the potential to enhance the value for money delivered by SCFII. This is because VFM calculations presented in this evaluation assume no return of SCFII invested funds.
- SCF depends on successful operation of angel syndicates and the continued support those angels receive from national (UK) tax incentive schemes – most notably SEIS and EIS. All those engaged in the market for early stage risk capital need to acknowledge and promote the role of the business angel.
- SIB needs strong, professional and well administered angel syndicates to operate the SCF as a market-led Fund. This will continue to require careful selection and selective development of syndicates to ensure SIB can maintain a *pari-passu* approach to investment, giving the market its place in appraising and selecting investments and optimising the costs of engagement for the public sector. To date LINC Scotland has played an important role in developing and providing ongoing support to emerging syndicates. It may also have a role, going forward, in continuing to develop syndicates.
- There is a case for increasing the ceiling for the SCFII contribution and deal size, given both the passage of time since these were last reviewed in 2007 and the observed migration of VC investors to higher deal sizes.
- There are innovations in the market within which SCFII operates including Crowd-funding and hybrid models including both crowdfunding and angel syndicates. SIB and its partners need to be alive to these innovations and explore ways in which they can be used alongside SCFII to optimise the availability of equity funding for young innovative businesses which add value to the Scottish economy.

APPENDIX 1

SCF ELIGIBLE ACTIVITIES

To be considered for investment from the Scottish Co-investment Fund a prospect company must:

- Be a commercially-viable business
- Have, or be in the process of developing, a significant operational presence in Scotland which is proportionate to the levels of investment being sought
- Fall within the EU definition of a Small to Medium Enterprise (SME)

The SCF is not sector-specific but certain activities may be restricted, including:

- Real estate/property development
- Social and personal services
- Pubs, clubs and restaurants
- Local services
- Banking and insurance
- Motor vehicles
- Nuclear decommissioning
- Professional services
- Retail

APPENDIX 2

SIB SUMMARY OF:

Equity Research Report. Review of Equity Investment in Small Businesses. British Business Bank and DBIS March 2015

INTRODUCTION

Early stage equity funding is a small but disproportionately important part of the UK economic landscape. For a specific group of businesses with the potential for high growth, but whose risk level makes bank finance unsuitable or unavailable, external equity finance is vital to enable them to achieve their full potential. This makes equity investment an important component of industrial and entrepreneurship policy. The SME Finance Monitor shows that around 1% of businesses currently use equity from third parties (such as venture capital funds or business angels), and less than 1% apply in a given twelve month period. By contrast, around 4 in 10 businesses use any form of external finance.[31] Analysis by Ares & Co[32] estimates that, by value, equity accounts for around 5% of total external financing used by smaller businesses, which suggests the average small firm equity deal is larger than the average debt deal.

It is clear that the smallest and newest businesses are most likely to be rejected for a debt facility[33]; this also feeds the perceptions of smaller firms and reinforces a desire to postpone applying for external facilities and relying instead on internal sources of finance for as long as possible. Only a very small proportion of the deal-flow receives equity investment[34], further reducing the desire for most businesses to actively seek equity given the large amount of time spent identifying and pitching to potential investors.

A comparison of VC investment as a proportion of GDP shows the UK market generally exceeds its European competitors, but lags behind the leading world players of Israel, the USA and Canada.

Activity through Enterprise Capital Funds and the Angel CoFund already delivers investment capacity of over £650m, making BBB the biggest single provider of funding in the UK in this part of the market.

WEAKNESSES & GAPS

Despite the increasing use of equity finance, the paper identifies several weaknesses in the market: the persistence of the equity gap, especially at the venture stage; a lack of institutional investment; lack of awareness of finance options on the part of small businesses; and insufficient data for more detailed analysis of market trends. Structural failures in the market are well-established and understood. The informational asymmetry[35] between business and investor necessitates costly due diligence in advance of any deal; this cost is relatively fixed, meaning it accounts for a greater share of smaller deals, which drives

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[31] BDRC Continental (2014) "SME Finance Monitor Q3 2014", available at: http://www.sme-finance-monitor.co.uk

[32] Ares & Co (2012) "SME Financing: Impact of regulation and the Eurozone crisis"

[33] For loan applicants, the overall success rate in the period Q2 2013-Q3 2014 was 56%; success rates varied from 48% for firms with no employees to 93% for firms with 50-249 employees. For overdraft applicants over the same period the approval rate ranged from 73% for firms with no employees to 97% for firms with 50-249 employees. For loans and overdrafts combined, 45% of first-time applicants were successful, compared to 56% of all applicants seeking new money and 71% of applications overall (for new or renewed facilities). Source: SME Finance Monitor (http://www.sme-finance-monitor.co.uk)

[34] BIS (2009) "The Supply of Equity Finance to SMEs: Revisiting the Equity Gap" suggests on average VC funds invest in around 2% of the applications they receive, indicating fund managers are very selective in trying to identify the investments that will generate the highest financial returns.

[35] It addition to asymmetric information, there is a related failure that arises from an absence of information on the likelihood of success for seed and early stage businesses, especially for 'ground breaking' technology or products/processes that are completely new to the market.

funds toward larger deal sizes and larger/less risky firms. This gives rise to the classic "equity gap", first identified in the Macmillan Report as long ago as 1931[36].
The 2003 HM Treasury and Small Business Service "Bridging the Finance Gap" consultation[37] identified an equity gap affecting VC deals of up to £2m, and provided the basis for the establishment of the Enterprise Capital Funds (ECF) programme. The most recent published assessment of the equity gap, carried out by SQW, confirmed the existence of an equity gap, and placed the investment range at £250,000 to at least £2m, and up to £5m or more in certain (technology-intensive) sectors[38].

The nature of the equity gap is also discussed in forthcoming research evaluating British Business Bank equity schemes. The stakeholders interviewed suggest that, by 2014, there was reasonable availability of seed-stage finance towards the lower end of the "traditional" equity gap, as business angels have become involved in larger deals due to greater levels of syndication, the expansion of EIS and VCT investment limits to £5m per year, and the introduction of SEIS, the latter two of which occurred in 2012. Despite these changes, there was a clear view that an unaddressed gap persists for investments of between £2m-£5m.

This new research is consistent with the findings of a 2013 CfEL survey of fund managers delivering publicly-backed funds, in which the majority of managers put the upper limit of the equity gap at £3m or more, and 1 in 3 specifically put it at £5m[39].

This range is above the previous State Aid limit for the ECF programme – although the limit recently increased to £5m for new funds, starting in November 2014. Some other British Business Bank schemes are able to invest in this space, such as the new VC Catalyst Fund and the UK Innovation Investment Fund; the latter has been a significant investor at the growth stage but is now fully committed, whilst the former is only beginning to make investments. Companies receiving EIS and VCT investment have also been able to access up to £5m since 2012, and have likely made a positive impact in this space, but it is hard to judge the extent of this: detailed data on investment patterns are scarce, particularly for VCTs. The recent extension of the ECF programme offers the chance to make a further impact on the later-stage equity gap, building on the other programmes.

The Business Growth Fund (an independent investment company with £2.5bn to invest, funded by five major UK banking groups) makes investments in this space (£2m -£10m) for a minority equity stake, but typically in more established companies with sizeable turnover, so still misses out a range of businesses that are early or pre-revenue, typically in tech-focused sectors with long product development times.
The gap in venture-stage investment, according to Beauhurst data, is most notable in the £2m-£5m range, where levels of investment decreased from 2011 to 2013, before experiencing a rebound in 2014. Separate data from the EVCA supports this conclusion, showing that "earlier stage" (seed) investment seems to have held up well since the

[36] The Macmillan Report described a long term funding gap which has come to be known as the equity gap
[37] HM Treasury (2003) "Bridging the finance gap: a consultation on improving access to growth capital for small businesses", available at:
http://webarchive.nationalarchives.gov.uk/20081113023136/http:/www.hm-treasury.gov.uk/d/adinvest359kb03.pdf
[38] SQW Consulting (2009) "The Supply of Equity Finance to SMEs: Revisiting the 'Equity Gap'"; available at
http://www.sqw.co.uk/files/8713/8712/1030/47.pdf
[39] Capital for Enterprise Ltd (2013) "2013 Survey of Fund Managers", available at
http://british-business-bank.co.uk/wp-content/uploads/2013/10/Fund-manager-survey-2013-report-final.pdf

financial crisis, but that "later stage" (venture) investment and fundraising have seen reduced investment.
The widened equity gap has been recognised by the British Business Bank and Government, with the key policies adjusting to reflect the scarcity of funding in the £2m-£5m space. Firstly, in 2012 the investment limits for EIS and VCTs were increased to £5m; then in 2014 the ECF programme extended its own investment limit to £5m, with the first new fund with these rules closing in November 2014. On top of these changes to existing schemes, there was also the introduction of the VC Catalyst Fund in 2013, which supports capital-raising in funds towards the later stage of venture, with no limit on investment sizes.
The BVCA paper[40] also offers some support for the notion of "bifurcation" of the VC market, as funds either move up into larger funds or focus on smaller funds.

DEBT

Forthcoming research by the British Business Bank shows that, despite its potential to fill an important gap in the funding landscape, the market for small business growth loans is underdeveloped in the UK, with a number of structural market failures affecting both the supply and the demand side restricting this market from becoming established.
These market failures are similar to those affecting equity finance for small firms, and include issues relating to the cost of undertaking due diligence relative to transaction size; the lack of a proven track record for this asset class with investors; and constraints on attracting institutional investment into small funds. There are also demand-side barriers, including a lack of awareness of growth loan products and providers on the part of small businesses, and issues relating to investment readiness in how firms market themselves as investable propositions.

EXITS

Two potential alternatives might arise from this analysis. Firstly, it may be the case that a fundamentally different sort of "patient" investor is called for. The types of investor likely to be willing and able to invest over a longer time horizon might include corporates, institutional investors and some business angels. There is a small but growing number of evergreen investment vehicles that suggest some investors are more "patient" in outlook.
From a European perspective, the exit market has been characterised by both an absolute weakness in falling IPO activity and a relative weakness in a lack of trade sales compared to the USA[41].
However, more recent data from Dow Jones VentureSource[42] provides some cause for optimism. It shows liquidity has improved in the European VC market during 2014, driven mainly by an increase in IPOs: there were 55 IPOs in Europe in 2014, compared to just 18 in 2013, which suggests there is some making up for the lack of listings in recent years. Trade sales saw a relatively more modest, though still significant, increase (from 152 deals in 2013 to 181 in 2014). There is hope, therefore, that the weaknesses in exit markets which have

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[40] BVCA (2014) "VC Evolved", available at:
http://www.bvca.co.uk/Portals/0/library/documents/VC%20Evolved/VC%20Evolve%20Brochure%202014.pdf

[41] BVCA (2013) "European Venture Capital: Myths and Facts", available at:
http://www.bvca.co.uk/Portals/0/library/Files/News/2013/European_MandF_Report_21Jan13.pdf

[42] Dow Jones (2014) "Venture Capital Report" available at
http://images.dowjones.com/company/wp-content/uploads/sites/15/2015/01/VS_Report_Europe_4Q14.pdf

likely affected returns and deal-making in recent years might become less of a problem in future.