Angel to VC – Bridging the Series B Gap

This is our first very detailed blog focussing on the Series B gap in the market with regards to why it exists and what can be done about it. We have also included some of the other challenges start-up firms will face in their early days. In our next blog, we will be focussing on some of these challenges and potential solutions to them, so stay tuned!

There has been a huge increase of investment into angel backed companies in the UK. Will they all be capable of raising the larger Series B (first VC investment) required to grow to a strong exit?

There is growing evidence that many start-ups cannot get to the requisite size on angel funding alone to be attractive to VCs and thus falter. Is there a formula for the more savvy start-ups to succeed in winning this follow-on investment?

The Angel Growth Story in the UK

*Angels provide **over 90%** of outside equity for start-ups and it is becoming an increasingly attractive alternative for businesses searching for capital to grow.*

There are numerous reasons as to why angel investing has been increasing and like in any market - there is a supply side and a demand side to the story.

The supply of start-ups for angels to invest in has increased over the past decade mainly due to technology providing opportunities for low capital intensity businesses to set up and grow rapidly.

The disintermediation of the middle-man (physical stores vs internet shopping) and optimisation of resource usage enabled by technology (resource efficiency example - Airbnb) are key themes for these businesses.

In many sectors, it has never been easier to inexpensively and quickly set up a business – with outsourced cloud IT, cheap global communications, office sharing and part-time staff and consultants working from home. So from a capital perspective, in most cases, you need less capital than ever thanks to the rise of technology in order to get a venture off the ground.

According to data from *"Growth Business"* the UK is one of the cheapest places to start a start-up with **0.7% of gross national income start-up cost for UK businesses** (compared to the global average of **20%**).

Other advantages start-ups enjoy today more than in decades gone by are:

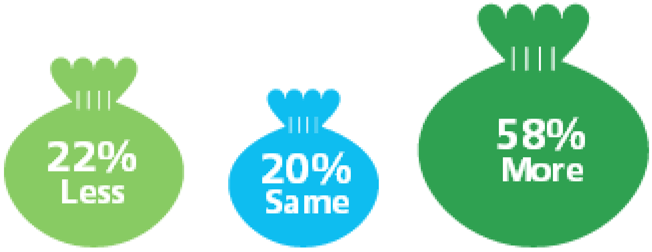
- **Mentorship:** Access to mentorship through angel investment, venture capitalists as well as online networks makes it easier to access contacts who can help
- **Accelerated Learning:** Today entrepreneurs have access to a huge library of information that can be leveraged to their own success
- **Licensing:** Business models which allow multiple licensing are extremely attractive

On the demand side – angel investors are also hungry for opportunities, buoyed in the UK by tax breaks and the attraction of potentially high returns from capital light businesses.

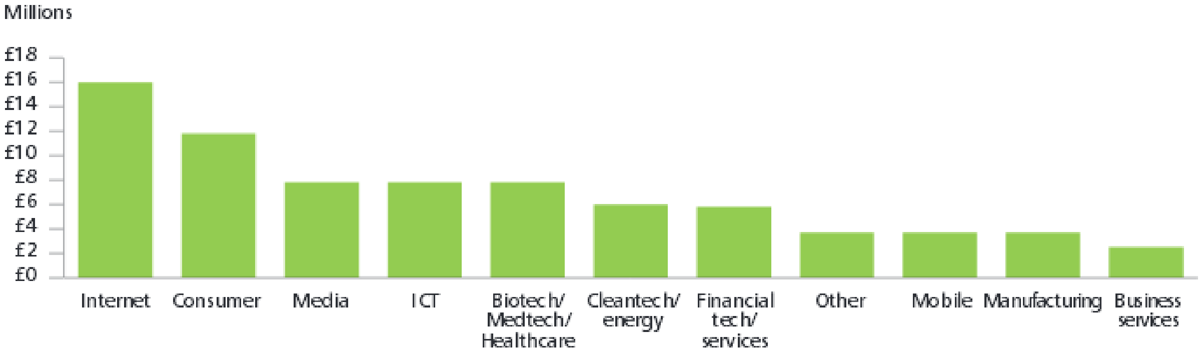
The tax break vehicles available in the UK for early stage investing include EIS investing and VCT investing (full description at the end). Coupled with the Angel Co-investment Fund capitalised by the UK Government and it has never been a better time for entrepreneurs to try and raise seed capital.

Amounts
There are currently **18,000** angels according to the UKBAA which invest annually approximately **£850m**.

Last year, **58% of angels** said they are investing more than in previous years.



In terms of sectors, **Internet** and **Consumer** are amongst those receiving the most investment.



Of the **619,000 millionaires** in the UK, only **5%** are Business Angel Investors and therefore the government is using schemes such as EIS and VCT to fill this gap.

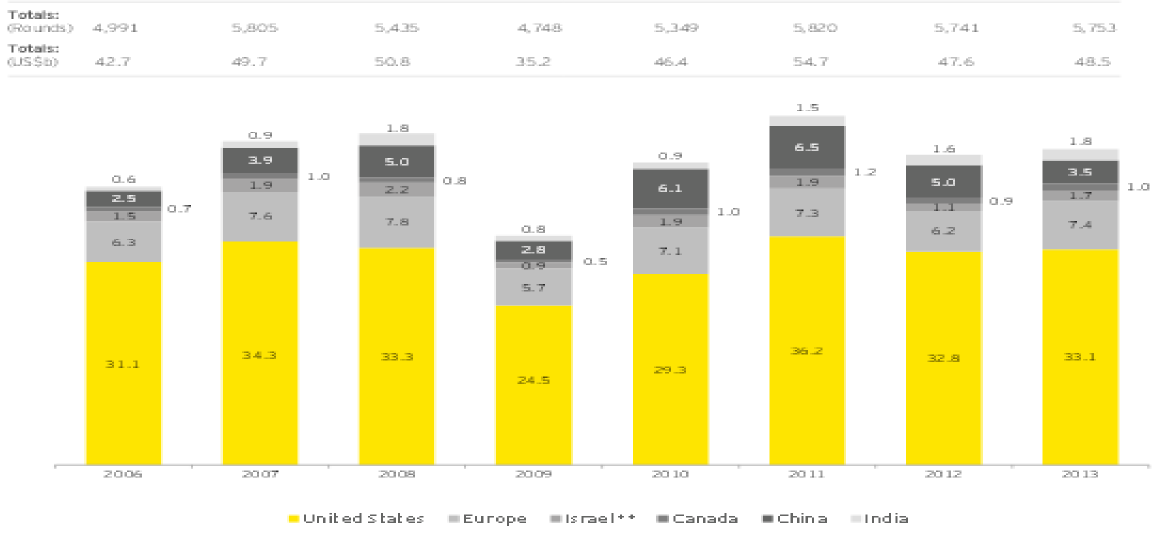
Venture Capital is growing but prefers more developed opportunities

Despite the trials and tribulations of smaller funds with below average returns trying to raise further capital – VC investing worldwide is still increasing. This is mainly due to successful funds raising larger follow-on funds and filling the gaps left by the unsuccessful funds. However, these larger funds are now looking for larger opportunities to put their increased capital to work. Series B financing is the area that suffers as these funds screen for larger deals.

Venture Capital Investment Data

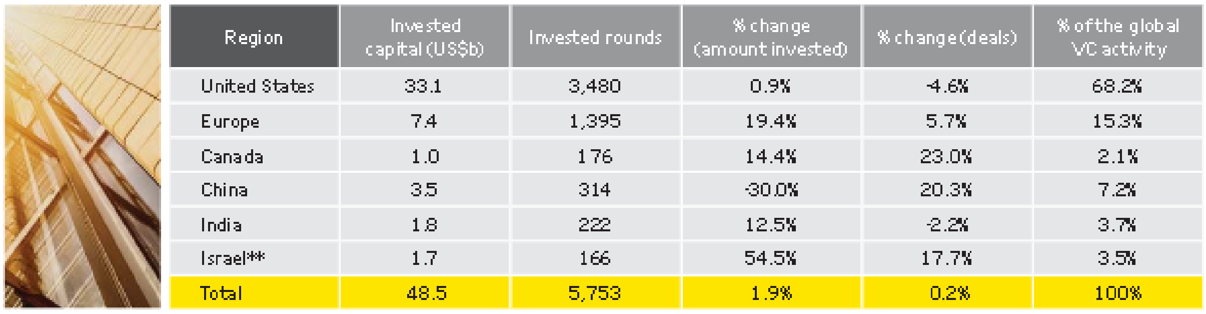
Globally, venture capital has seen a positive year with investment levels increasing by **2%.** However in Europe the outlook has been much better with a **19%** rise in capital invested and a **6%** rise in the number of deals completed. It should be noted however, Europe only accounts for **15%** of global venture capital activity.

Global annual VC investment 2006-13



Source: Dow Jones VentureSource, 2014
**All-site Israeli companies

VC investment by region 2013



Region	Invested capital (US$b)	Invested rounds	% change (amount invested)	% change (deals)	% of the global VC activity
United States	33.1	3,480	0.9%	-4.6%	68.2%
Europe	7.4	1,395	19.4%	5.7%	15.3%
Canada	1.0	176	14.4%	23.0%	2.1%
China	3.5	314	-30.0%	20.3%	7.2%
India	1.8	222	12.5%	-2.2%	3.7%
Israel**	1.7	166	54.5%	17.7%	3.5%
Total	48.5	5,753	1.9%	0.2%	100%

Source: Dow Jones VentureSource, 2014
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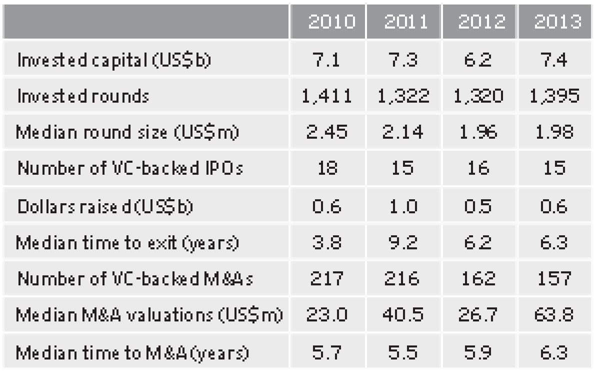
Key Europe VC statistics



	2010	2011	2012	2013
Invested capital (US$b)	7.1	7.3	6.2	7.4
Invested rounds	1,411	1,322	1,320	1,395
Median round size (US$m)	2.45	2.14	1.96	1.98
Number of VC-backed IPOs	18	15	16	15
Dollars raised (US$b)	0.6	1.0	0.5	0.6
Median time to exit (years)	3.8	9.2	6.2	6.3
Number of VC-backed M&As	217	216	162	157
Median M&A valuations (US$m)	23.0	40.5	26.7	63.8
Median time to M&A (years)	5.7	5.5	5.9	6.3

Source: Dow Jones VentureSource, 2014

While the performance outlook in Europe is greatly improving with investment rounds up more than **5%** and the value of investments up by **19%**, the ***UK is the real star***.

In the UK, investments were up a **staggering 21% accounting for 30%** of overall activity across the EU.

The Issue - Series B Deficit

As a result of the tax incentives from EIS/VCT companies are raising seed capital relatively easy and hence angel investment is growing. However, this leads to too many companies attempting to raise Series B investment, many without the appropriate expertise or market traction. Therefore it becomes a difficult proposition to sell to investors and hence the Series B struggle.

The Challenges faced by start-ups as they try to raise further capital

We have segmented the challenges into three areas Operational, Financial Control & Governance and Proof of Business Model. The challenges below are not conclusive but are commonplace. Going forward we will look at the solutions.

Angel backed company -typical problems investors don't like to see	
Operational challenges – doing good business	
1.	Little ability to negotiate with larger initial customers whose systems and contracts are set up for dealing with more mature stable suppliers with stronger balance sheet.
2.	Terms with suppliers: Gross margin pressure as companies do not have the purchasing power to drive costs out of the value chain at an early stage. Vicious circle develops as suppliers demand upfront payment due to the weak balance sheet of the start-up and further pressurises cash flow.
3.	Team has been in start-up mode and have not the businesses processes in place to handle even moderate growth. The founders of a new company struggle to make the transition from being entrepreneurs to business managers/leaders and therefore need external support. This can include founders struggling to grasp and solve the issues listed here.
4.	Weak board reports – not focussed on the necessary KPIs which then cascade to weak management measurement criteria at the lower levels. What get measured – gets done.
5.	Founder dependence: If a company is too dependent on one individual and cannot stand on its own two feet for any length of time without them then this can create problems. An example would be if the founder cannot let go of certain decisions and responsibilities as the company matures.

Financial Control & Governance issues	
1.	Valuation mismatch: Common issue where Angels have invested at somewhat inflated valuations and the VCs do not view the company as an investable proposition at that valuation, hence look elsewhere. The company struggles to raise the capital needed to grow and expand.
2.	Working capital financing – extensive working capital needed for ramp up due to mismatch in terms from suppliers and customers or not getting market terms.
3.	Strategic finance: Some start-ups suffer from lower than necessary financial modelling ability to present information properly and run different scenarios to present internally to decide strategy and to present to investors.
4	Cash management: The company has not planned for invoice delays and/or lacks the appropriate expertise to deal with such situations financially.
5.	Transaction expertise: Many Angel backed companies may be first time ventures for the CEOs and exec teams and do not have a CFO – important for: • Running DD • Deal terms negotiation
6.	Board dysfunction: Too many competing angel voices at Board level – all well-meaning, however potential noise for a CEO.
7.	The Board has not executed any form of contingency planning for various scenarios leaving the company wide open to problems if such scenarios were to occur. Or, the Board lacks the expertise to perform a thorough analysis to understand contingency planning and what course of action to take in certain circumstances.

Business Model/Competitive advantage not proven	
1.	Lack of commercial traction: When a company attempts to raise Series B Financing without adequate commercial traction it will be challenging. At the same time, a company may be in a situation where it does not have enough Angel backing to survive or to change strategy late in the day creating a wind-up situation.
2.	Wrong initial 'go-to' market' strategy: The company uses up its angel funding with the wrong market strategy or with the wrong partners on board – not proving the value proposition. The issue here is that you cannot have multiple attempts and keep constantly changing the business model in quick succession – you run out of money.
3.	A company may have its valuation deflated by a lack of protection over its intellectual property. This is especially the case if the company has not adequately diversified through a wide product range and therefore is deemed high risk by investors. This will cause a problem if a competing company with larger resources and economies of scale attempts to drive you out of the market.
4.	The company can have issues in generating credibility with suppliers/customers due to a zero track record. This problem can then be exacerbated in an industry where there are high levels of intense competition. In this situation, a company may resort to shrinking margins in order to win over competition but this can then create financial problems.
5.	Client dependence: If the company is dependent on one client that makes up more than half of income then this can cause problems if that client leaves increasing the overall risk of a company.

*According to The Financial Times Guide to Business Start Ups, after **2.5 years** they found that **20%** of failed businesses would still exist had they sought the appropriate support from the start.*

The above challenges can be overcome with enough foresight and planning. This is vital in a UK capital market where there is intense competition among angel backed companies for Series B financing. We will examine some potential solutions to these problems over the coming weeks.

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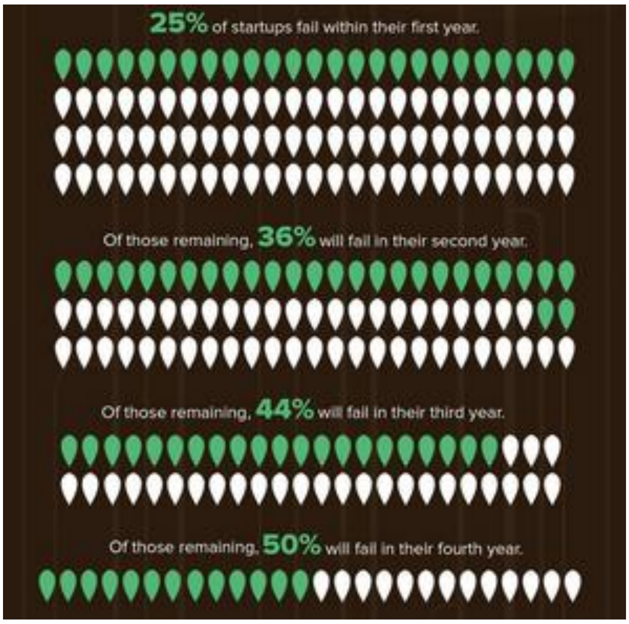
Thanks to William Johnson - White Lake Intern

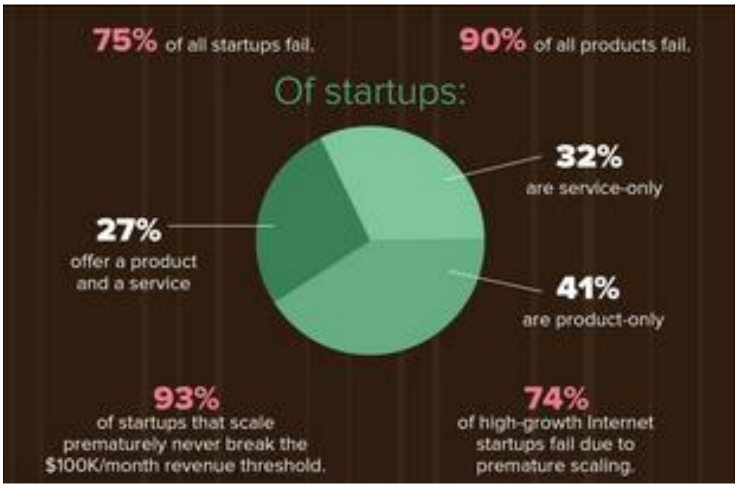
Appendix:

Start-Ups

Success Rate

According to research by Harvard Business School, the reality is a lot of start-ups often go nowhere. In fact, as many as **75%** fail. If that sounds bad, then ***even more fail*** if they are not supported by venture capitalist funds or angel investors usually because the business runs out of capital if the initial model does not work out as intended. The infographic below explains:





From a pure **UK Perspective**, the statistics are slightly different but similar.

In **2012**, there were **424,161** new start-ups created and **9,799** were in November alone.

So far this year, there have been **365,200** newly created start-ups.

SMEs saw a whopping **38.7%** growth from 2000 to 2012 from **3.5 million** to **4.8 million**, an overall increase of **1.3 million over just 12 years**.

In the UK, **33%** of businesses fail within their first three years:

- **20%** will fail in their first year
- **50%** will fail in the three years following

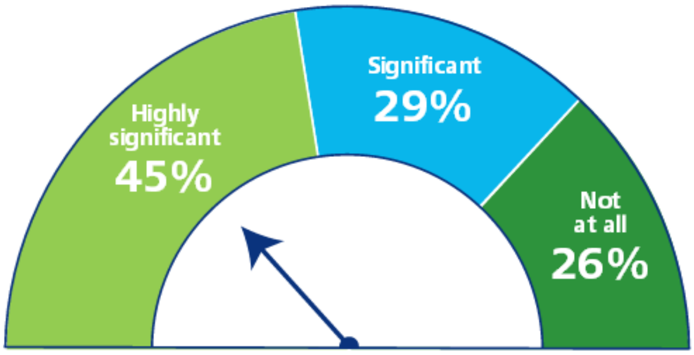
EIS Investing (Enterprise Investment Scheme)

EIS or Enterprise Investment Scheme is one whereby investors who purchase new shares in smaller trading companies are eligible to receive a range of tax reliefs given the high risk associated with such companies. The ultimate aim is to make it easier for these institutions to raise capital and therefore, grow.

EIS Investing follows these basic rules and principles:

- All shares must be paid in full, in cash, when they are issued
- All shares must be ordinary, non-redeemable and have no preferential rights to the company's assets in the event of it winding up
- Shares are allowed to carry preferential rights to dividends but may not include rights when either:
  1) The rights attaching to the share include scope for the amount of the dividend to be varied based on a decision taken by the company, shareholder or any other person
  2) The right to receive a dividend is *cumulative*
- No arrangement must be in place to protect an investor from the normal risks associated when investing in shares
- No arrangement must be in place for the shares to be sold at the end of the relevant period
- Shares must not be issued under any form of *"reciprocal"* agreement which may include, but is not limited to, where owners agree to invest in each other's companies to obtain tax relief
- No arrangement must be in place (at any time) to structure a company's activities with the main purpose of allowing a party other than the company itself to benefit from:
  1) Tax advantaged finance which the scheme is intended to incentivise or
  2) Where an activity has no commercial purpose other than to generate tax relief
- The company must have less than 250 employees and less than £15 million gross assets

Last year, **74% of angels** said the EIS was either *significant* or *highly significant* in their decision to invest. Furthermore, **58%** of angels said they would have invested less or not at all without the scheme.



History

Today's EIS has developed from a scheme launched in 1981 entitled the *"Business Start-Up Scheme"*. In 1983, this gave birth to the *"Business Expansion Scheme"* which was designed to encourage private investors to provide venture capital for unquoted companies, initially for a minimum of five years. The scheme was originally launched as SMEs found it difficult to access bank finance – similar to today. The solution to this problem was born in the format of tax incentives. Unfortunately, in some cases, the scheme was used for the wrong reasons and so today's scheme is one with detailed rules but ultimately with the aim of helping unquoted trading companies raise capital.

VCT Investing (Venture Capital Trusts)

VCTs or Venture Capital Trusts are similar to an EIS in that investors may be entitled to a range of Income Tax and Capital Gain Tax reliefs. A VCT is a company trading on a regulated market run by fund managers. The VCT invests in multiple higher-risk trading companies, providing them with financing to develop and grow with the aim of mitigating risk for the individual investor in the VCT through diversification. An investor can purchase shares in the VCT which acts as an indirect investment towards multiple higher-risk trading companies allowing the investor less overall risk exposure. Over the longer-term, the VCT itself will make new investments from time to time as well as disposing of investments (which are exempt from Corporation Tax) to yield a return.

VCT Investing follows these basic rules and principles:

- In order to be eligible for tax relief, you must invest in a company which has been approved as a VCT
- Its income for the most recent accounting period must have been either wholly or mainly from shares and/or other securities
- Throughout that period, at least 70% (by value) must have been shares or securities in companies which meet the conditions of the scheme (*"qualifying holdings")* and which were issued to the company and have been held by it ever since
- Throughout that period, at least 70% (by value) of its qualifying holdings must be in the format of non-redeemable ordinary shares with limited preferential rights to dividends or the company's assets in the event of it winding up
- At no time in that period must the holding in any company exceed more than 15% (by value) of its investments
- Throughout that period, its ordinary shares must have been listed on a recognised stock exchange
- It must not retain more than 15% of the income it derived in that period from shares or securities
- Throughout that period the VCT has not made an investment in any company which exceeds the £5 million maximum annual investment
- The company must have less than 250 employees and gross assets of less than £15 million

History

The VCT scheme started on 6 April 1995. Previously, VCTs were companies listed on the London Stock Exchange but from April 2011, VCTs are now companies admitted to trading in a regulated market.