Price Bailey
CHARTERED ACCOUNTANTS

Raising Venture Capital funding:

What it really takes for True Venture Entrepreneurs to access equity funding

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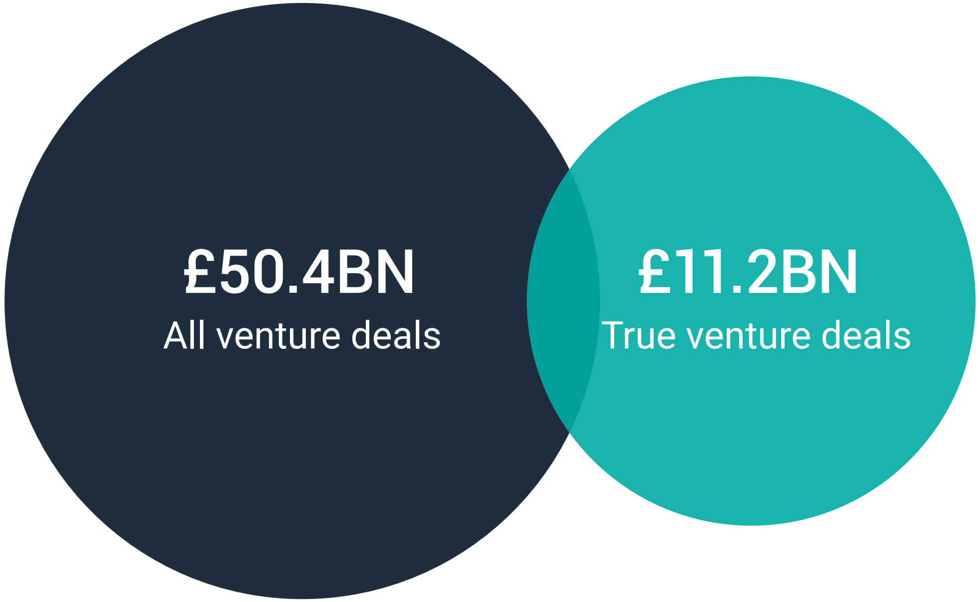
FY 2017 – Q1 2021 deals

Venture Capital (VC) provides lifeblood capital that helps potentially great businesses scale. When deployed at a meaningful quantum, it is typically administered through a fund. These funds have a mandate to invest in the traditionally perceived illiquid, risky, space of equity positions in unquoted (often loss-making) businesses.



This fuels innovation, jobs and technology to society. When successful, fund managers, investors, founders and their teams can make very healthy returns that can transform lives. Equity funding into these types of businesses is a critical part of moving an economy forward.

Price Bailey has been involved in VC funding for many years and has observed that, in some ways, the challenge of raising capital from VCs is getting profoundly harder for certain entrepreneurs.

The UK big picture is one where the overall Venture Capital (VC) market is buoyant, despite the impact of COVID-19. According to reports by Guardian and Pitchbook, \$15bn (~£11.2bn) of VC investment went into UK scale-up businesses in 2020, and KPMG have reported that £5.1bn of VC investment has already been invested into UK scale-ups in Q1 of 2021.

The big picture

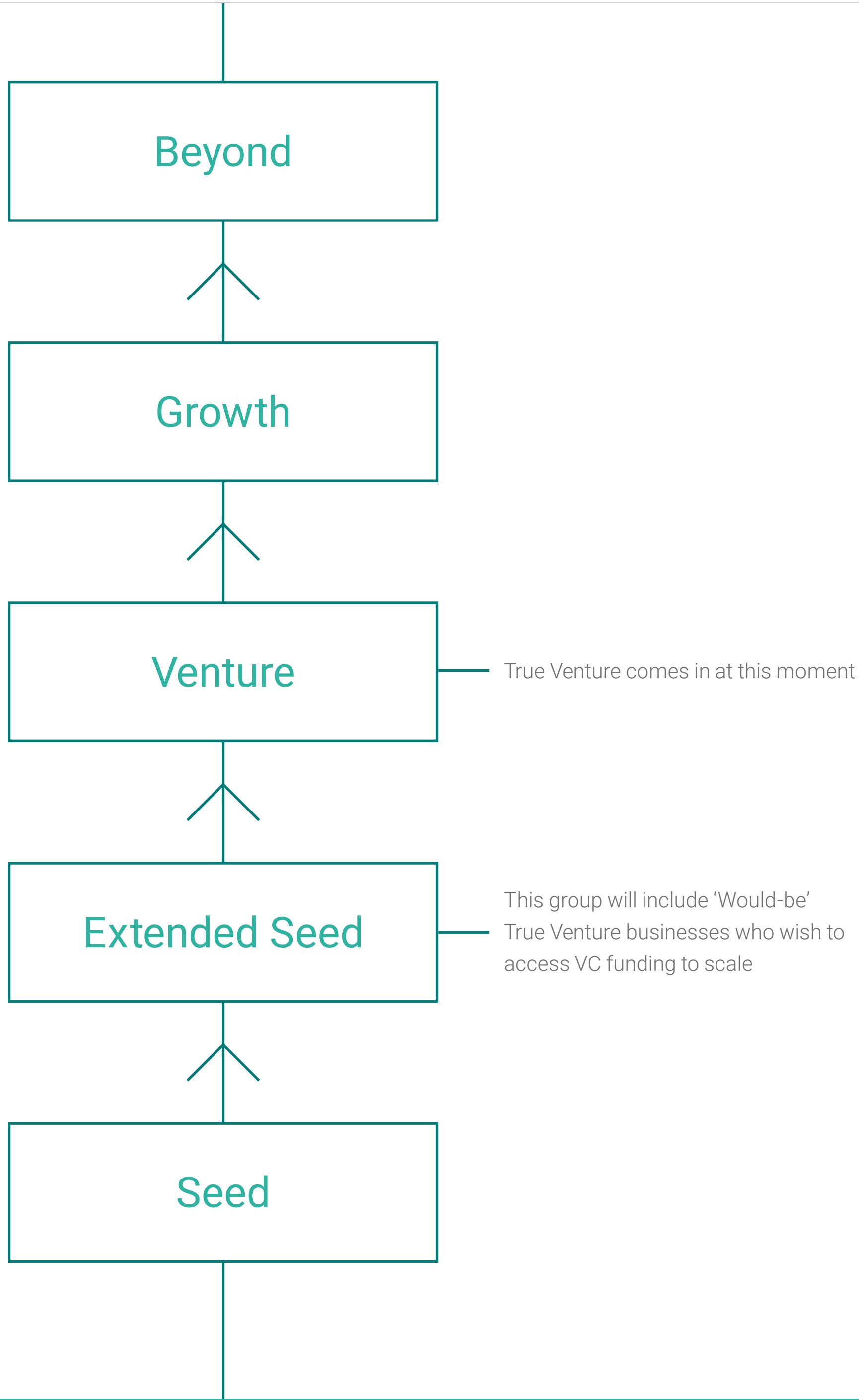
However, our concern is that these numbers don't provide an accurate reflection of the volumes and value of what we call True Venture deals.

What is a True Venture business?

- Unquoted businesses (e.g. limited companies).
- Aggregate equity funding of less than £1.5m followed by,
- An equity funding round of at least £2m.

We think this group qualifies as True Venture because, unlike the large VC deals that skew the big picture data by putting large amounts of capital into few businesses, this group have had to 'boot-strap' but have succeeded in raising their first round that would commonly be described as Series A funding. Because they have succeeded from humble roots, but are no longer in a start-up phase, they are True Venture.

We focus on UK businesses taking equity investment from UK and global funds, angel clubs and family offices where the deal size meets the £2m+ criteria.



The big picture

Using Companies House data and a variety of tools we have access to reports and data from PitchBook, MergerMarket, Beauhurst and beyond; we have analysed the 1818 companies in detail that meet the definition of True Venture and who raised their Series A round between the start of FY 2017 Q1 and the end of FY 2021 Q1.

When most people critique VC funding on the basis of size they are focussing on those at Seed stage that struggle to access funding. We're not talking about that group here and have stripped out early stage, seed type businesses. However, the picture still looks challenging for the True Venture class.

Despite the significantly lower deal activity in True Venture, according to the British Business Bank, there's £9.5bn of dry powder (cash to invest) among funds – meaning the money is out there. So why, as we see, are so few True Venture deals really completed? Realistically, it's likely to be one, or a combination, of two things:

- That many would-be True Venture businesses are not perceived as strong enough / are too risky; and/or,
- There's an inefficient system of deploying capital within the UK.

Both are interesting and put pressure on founders and funds alike to bridge the gap; but saying this does not help the would-be True Venture founder who wants or needs capital now.

Our specific advice to this group varies by sector and context, but this report should set out what those that have made it to the True Venture position have, and therefore what the would-be True Venture group can look to understand and develop.

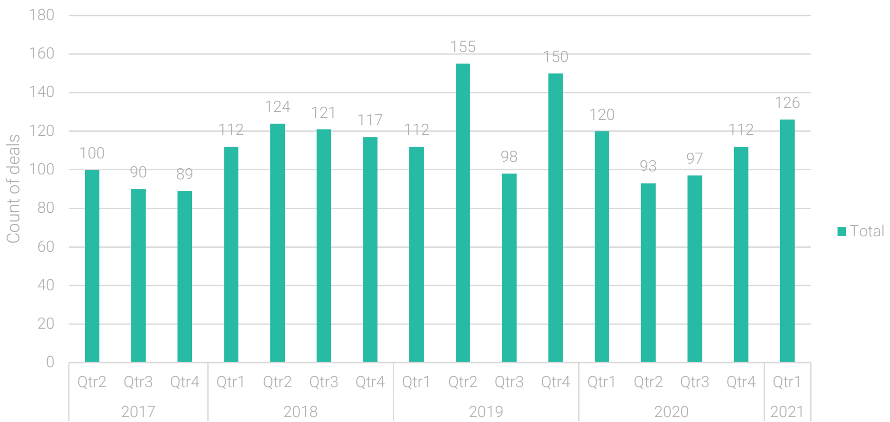
Therefore, with all of these things combined – we want to ask the question:

> Is there actually enough hope for would-be True Venture entrepreneurs in the UK VC market?

On the proceeding pages, we outline the key themes that emerge from the data on these 1818 companies.

True Venture UK Deal volumes

Quarterly deal volumes in True Venture



On average, every quarter between FY 2017 Q1 – FY 2021 Q1, only 114 True Venture companies received funding across the UK. While we do not know how many are trying to raise funding in total, we would expect it is significantly higher than 114.

We think these numbers are worryingly low and, of more concern, the trend line does not seem to be growing at any great rate. Therefore, despite an undeniably increasing amount of capital flowing to VC funds, we do not see this being deployed to True Venture entrepreneurs and companies.

This should, rightly, be a concern to would-be True Venture entrepreneurs. It should also be a cause of concern on an economic basis, particularly if non-UK funding eco-systems establish themselves as a better home for entrepreneurs. Globally, our view is that there is no shortage of capital, there is only a shortage of great entrepreneurs with investment ready businesses. Intuitively, more than 114 per quarter of these will be at the True Venture stage. Without a doubt, more needs to be done to develop a system that supports True Venture entrepreneurs to the point of being VC ready and encouraging investment within the UK.

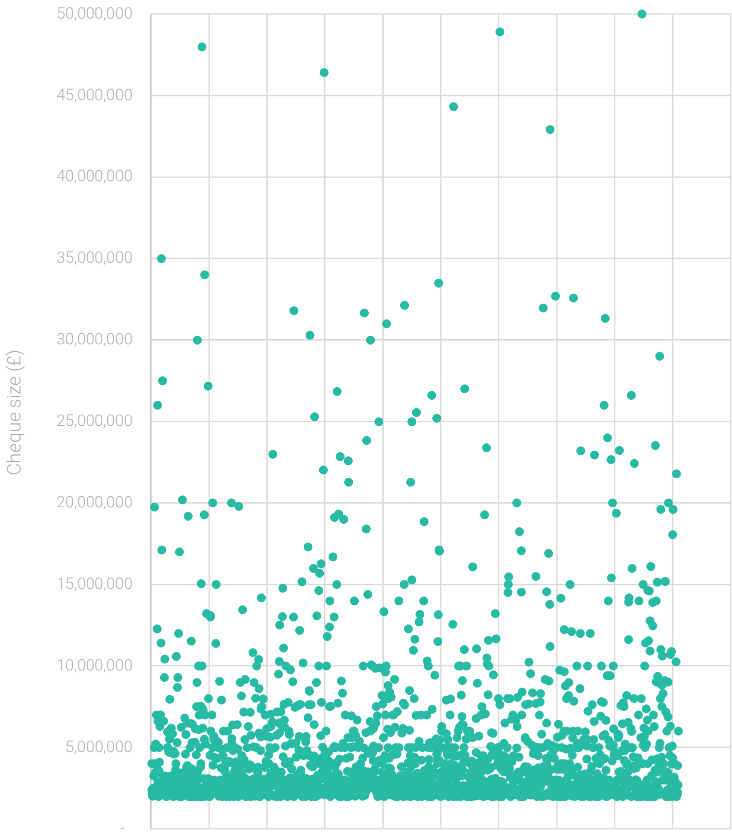
Interestingly, despite the conditions of 2020, deal volumes did not fall below norms throughout the year. What we cannot confirm from the data is the proportion of these deals that are shareholder re-investment designed to support their portfolio businesses through the pandemic and how much is true growth capital.

Key Takeaways:

- Raising True Venture funding is really tough.
- Only 114 deals per quarter complete on average.
- The cash is out there, but the supply and demand for cash do not match.
- Once again, raising True Venture is really tough.

Cheque sizes

Spread of cheque sizes in £2m+ equity deals, FY 2017 Q1 - FY 2021 Q1



This report sought to look at True Venture equity deals of at least £2m, with no upper limit. Yet, the above chart shows that 38% of True Venture deals are achieving cheque sizes of only between £2m and £3m, and 67% of all deals in the last four years have been less than £5m. Meaning that, according to data from the last four years, a True Venture entrepreneur who does successfully raise capital has a 1/3 chance of raising more than £5m.

Considering that all of these companies had less than £1.5m investment before the round that represents a dot on this graph, we think this is impressive and encouraging.

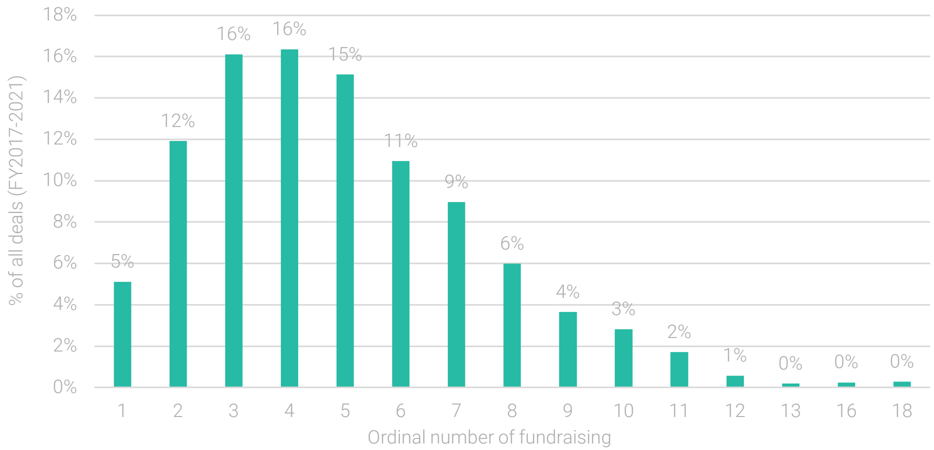
Key Takeaway:

If a company enters the True Venture category there is a roughly one third chance of raising

- £2m to £3m
- £3m to £5m
- £5m to £50m

Ordinal number in company's fundraisings

Chart showing the spread of ordinal number of fundraisings for True Venture businesses in FY 2017 Q1 -FY 2021 Q1



This chart looks at what sequential 'number' the True Venture round was for each company. A prior round can be any value where Companies House logged an issue of new equity to shareholders for cash subscriptions.

When we connect the cheque size to the cheque number it is clear someone has almost always already put money at risk before the True Venture round. Looking at the chart above, founders with few existing funding rounds to date struggle to raise £2m+.

Interestingly, 66% of deals occur for businesses who are on their 3rd to 7th round of funding. Albeit that, in aggregate, their previous rounds have to be less than £1.5m given the True Venture search criteria mentioned at the start (£1.5m or less of share capital). Nevertheless, it illustrates that previous investment, from angels and other funding sources, will be a key prerequisite to getting a business to the point it can attract investment from a VC. Looking at that figure from the other side of the coin, what it also tells us is that only one third of businesses raise up to three small rounds and then a major one. We were surprised that the number of businesses that could move from just 1, 2 or 3 small funding rounds to a major round was so low.

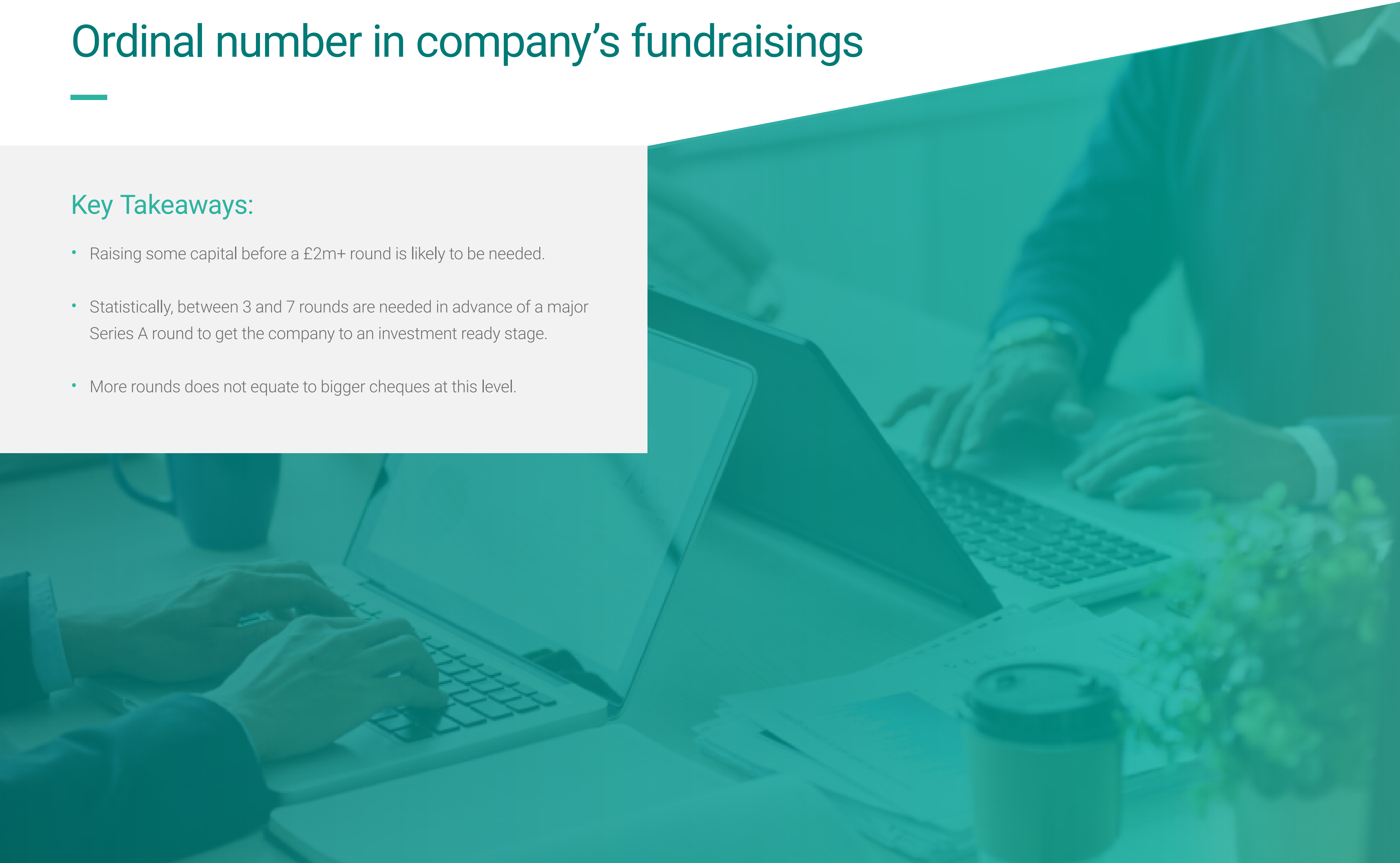
Within the dataset of True Venture, there is perfectly no correlation between cheque size and cheque number which is contrary to what most anecdotally believe. The nuance is that entrepreneurs with some, but less than £1.5m, of equity funding have a different experience to those ahead of them, where the order of the funding round is correlated to funding quantum.

It is this metric that appears to be a defining feature, as even those businesses that achieved above mean average cheque sizes still had no correlation with cheque number. However, we think it is interesting and potentially even dangerous that this phenomenon, which occurs for businesses just slightly further along in their development, is presumed to occur for businesses just one stage earlier (i.e. at the True Venture stage).

Ordinal number in company's fundraisings

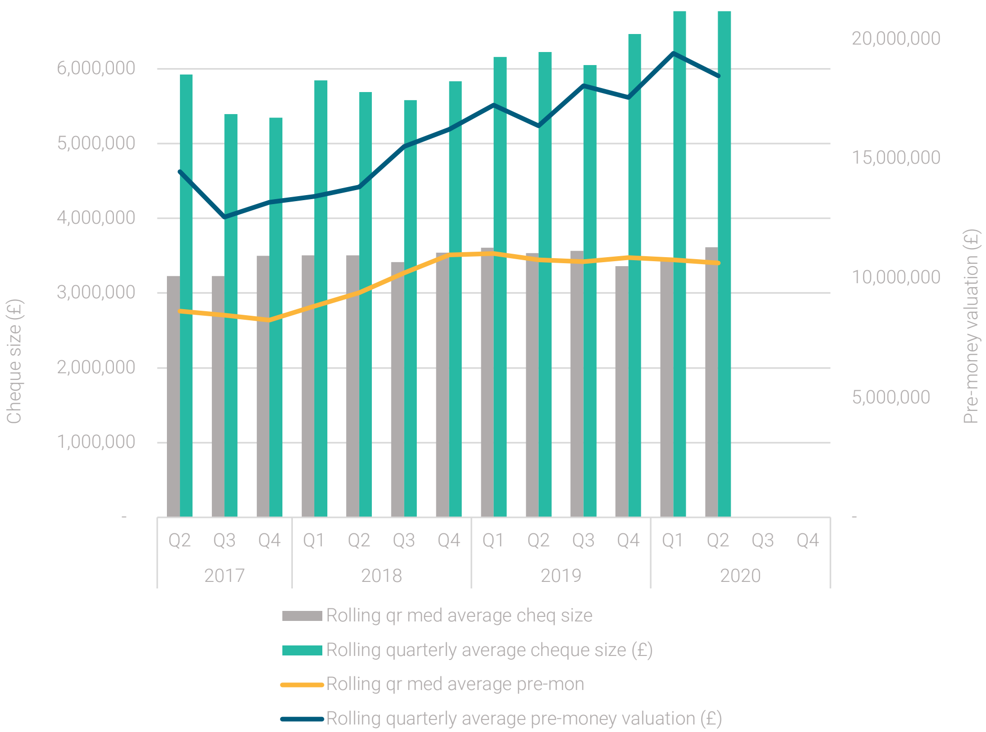
Key Takeaways:

- Raising some capital before a £2m+ round is likely to be needed.
- Statistically, between 3 and 7 rounds are needed in advance of a major Series A round to get the company to an investment ready stage.
- More rounds does not equate to bigger cheques at this level.



Mean to Median funding gap

The Mean to Median funding gap for True Venture



Without wishing to provide a statistical overkill, we think mean to median analysis is always interesting. It is normally the place where statistics hide lies.

The majority of funding reports will report trends on the basis of mean averages. However, this does not always show the true nature of these trends, instead median averages provide a clearer picture as it is a better measure of central tendency and is not skewed by significant outliers in the data. The mean to median differences in equity funding amounts and valuation are shown in the chart above.

The chart demonstrates the significant difference in how much funding True Venture businesses really receive. Clearly, the median, or what 50% of businesses experience in regard to cheque size is far lower than the mean average; this gap is £3.5m by median to £6m by mean, or a 71% swing.

The valuation gap is £9m to £15.5m, or a 72% swing.

What we can conclude from this is that within the population of True Venture, an average (mean) business attracts over 70% more capital, at over a 70% higher valuation than a middling (median) business. While roughly 114 deals complete per quarter, only 29% attract a valuation that is equal to or above the mean average, and only 24% attract funding that is equal to or above the mean average. These are the businesses that we call the ‘premium’ category and the rewards for being a ‘premium’ business within this category will no doubt be even stronger than those in the mean average category.

Mean to Median funding gap

Our health warning to entrepreneurs, therefore, is to be sceptical about 'average' numbers and make sure their funding requirements are realistic in the context of the majority of the data as, broadly, only 1 in 4 will match the most common headline numbers for funding raised and valuation.

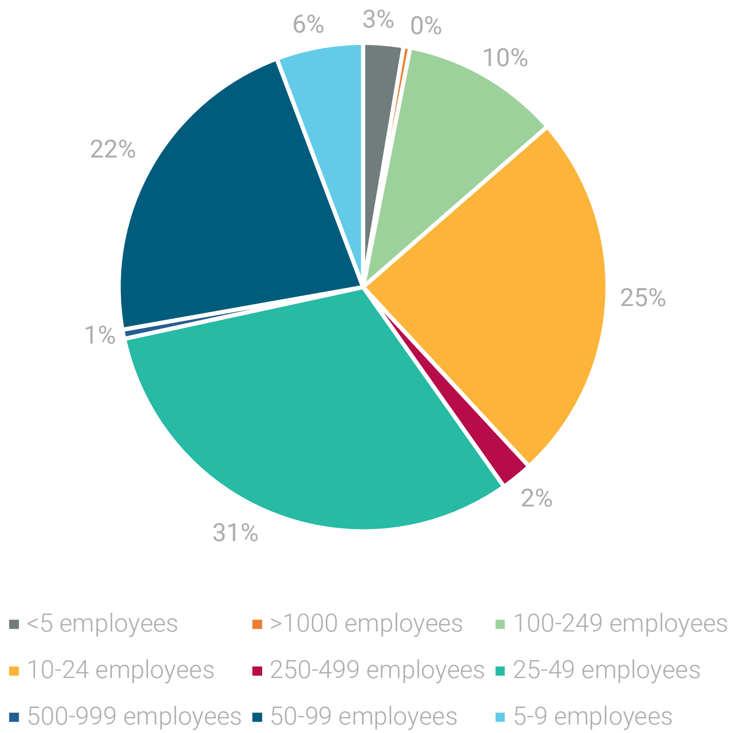
One thing to mention is that, from the data, we were not able to identify whether the use of other deal mechanisms (e.g., preference equity or convertible debt) that may be bolstering these inflated valuations and creating 'false' outliers.

Key Takeaways:

- The rewards for being a premium True Venture business are incredibly valuable.
- Premium True Venture businesses attract 71% more capital at 72% higher valuations than middling True Venture businesses.
- We know from experience that investors love finding premium businesses. It gives them a buzz. This means that when a would-be True Venture approaches a major investment player too early there is often silence or a polite "no."

Employee numbers

Pie chart showing the number of employees in companies that raised £2m+ of equity between FY 2017 Q1 - FY 2021 Q1

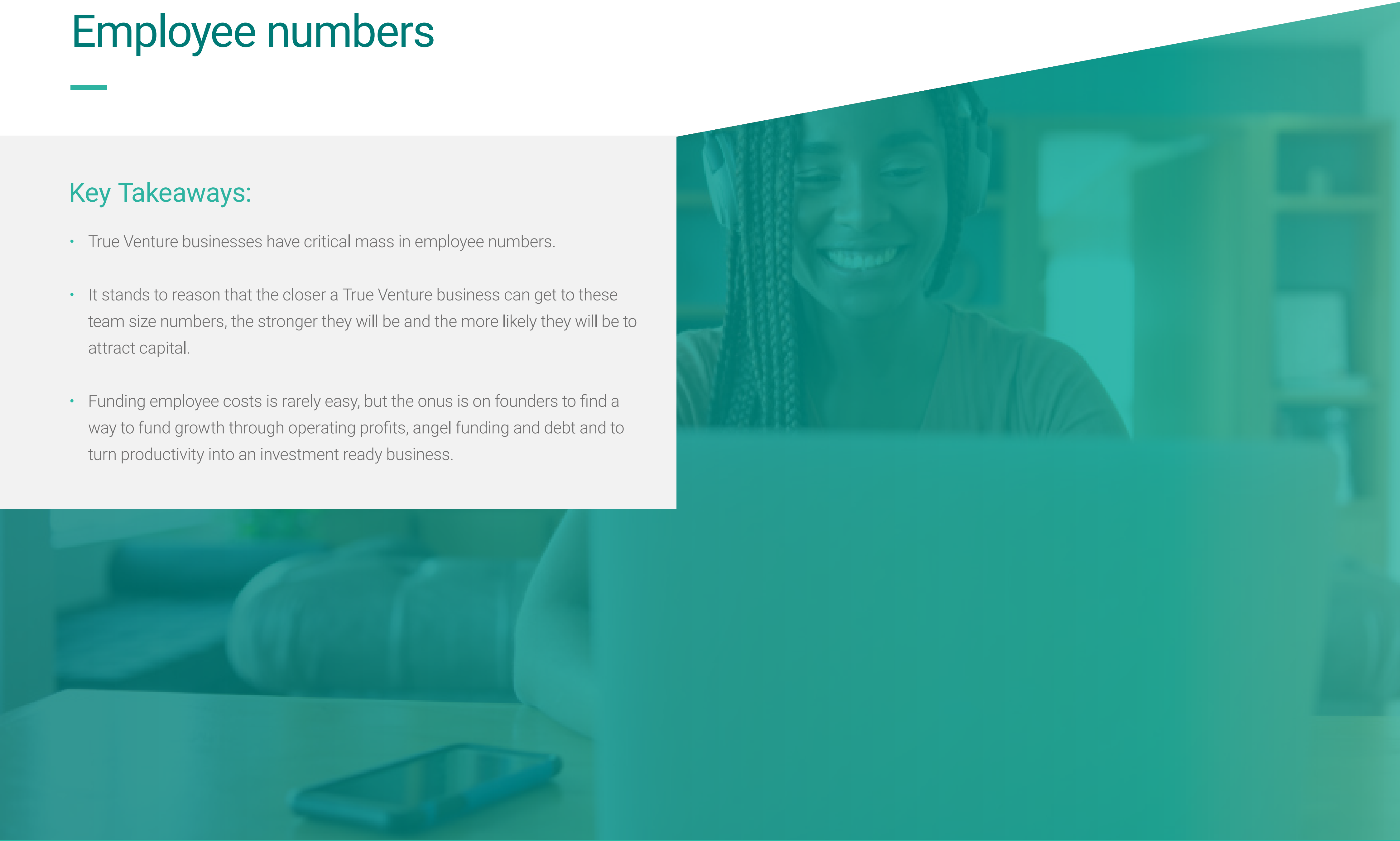


Employee numbers was revealed to be an interesting metric in the characteristics of True Venture businesses. This is useful as a proxy of critical mass, size, expertise and perhaps most of all, sustainability (remember that less than £1.5m of equity funding has gone into these companies).

What we found was that 65% of businesses raising £2m+ of equity have up to 50 employees (full and part time, excluding contractors). This level of critical mass and sustainability surprised us as were expecting far fewer employees within the True Venture group. However, the reality is that roughly 2/3 businesses already have a team that has a critical mass of employees in position. There may be some anomalies in the data, such as reporting on the final employee numbers at year end rather than as an average throughout the year.

The natural perception might be that businesses with 50+ employees (which for many founders will feel like 'a lot') and therefore more 'critical mass' will attract more capital on average. However, this is not necessarily the case as the data here demonstrated; the average equity funding amount was only 10% higher for businesses with 50+ employees. Therefore, we can imply that critical mass is a requirement for being average, rather than something that underpins driving a premium among True Venture businesses.

Employee numbers



Key Takeaways:

- True Venture businesses have critical mass in employee numbers.
- It stands to reason that the closer a True Venture business can get to these team size numbers, the stronger they will be and the more likely they will be to attract capital.
- Funding employee costs is rarely easy, but the onus is on founders to find a way to fund growth through operating profits, angel funding and debt and to turn productivity into an investment ready business.

Syndicates and co-investments

In the equity capital space both the funders and the entrepreneurs seeking funding will talk about common co-investment and syndicate relationships, with some entrepreneurs believing that if they can get X on board, then Y is more likely to follow. However, according to the data here there were no significant syndicate relationships found between VC investors in this part of the market, although the average number of investors per deal was 2 with 75% of the cheque size coming from the lead investor. The most common 'relationship' found was between undisclosed investors (assumed to be either private individuals, existing shareholders or pension funds) and a VC investor.

Regarding the prominence of VC funds in this space, BGF are the most frequent investor into True Venture, accounting for 9% of all deals, which still leaves plenty of 'market' for others.

Exits

Typically we would expect a True Venture investor to be invested for 5 to 7 years, though many want to remain longer and some, following tax reliefs, will try and exit after 3 years. Therefore, within a sample of 1818 True Venture businesses that received funding we would not expect to see too many 'exits' within this time period, though maybe we would be starting to see some failures.

In line with our expectations according to this data, there have been 63 exits from among the cohort of 1818 companies. 83% of these last raised £2m+ in 2017-2018 (i.e., the last investors in have sought an exit within 3-4 years).

However, almost as many businesses from this cohort have failed as have exited meaning that, even if you have achieved all the things mentioned in detail above, you still only have a one-to-one parity of success and failure over the first few years and, in the case of the 63 exits, we do not know if all have been successful post-exit and provided appropriate returns to investors.

The good news for many entrepreneurs is that it takes, on average, only 4 rounds of investment to get to the point of exit. Interestingly though, if we tie this in with the data on ordinal number of round, if it takes ~4 rounds to achieve a successful exit, but 1/3 of businesses are on the 5+ round then there may be a question of quality investment into True Venture businesses past this point. Without seeing the data behind the fundraising history of those businesses, share price fluctuations and business performance over that period, it is hard to determine.

Conclusions

The intention of this report is not to be 'doom and gloom' about the current state of the True Venture capital market. Instead, it is hoped that by looking at the data in this space it can provide a useful reality check, particularly to the entrepreneurs in this space who are seeking to raise meaningful investment.

The realities for True Venture founders, therefore, are:

- Only about 114 deals a quarter are completed in this space.
- If you want your first equity fundraise to be £2m+ without any funding to-date, realistically you only have a 5% chance of success.
- If the business can't support at least a decent crop of employees, you only have a 1 in 3 chance of succeeding.
- The rewards for being a premium business are immense, with valuation and funding levels in excess of 70% higher than par.

Realistically, there are a few companies that fit the profile, which is why the data shows so few transactions. We see many businesses try and race to Series A when they are simply not ready to provide sustainable, consistent commercial returns to investors. Sadly, many are not ready to be True Venture. For this group, taking advice, building carefully and strategically and boot strapping will continue to be key until the UK eco-system for VC funding develops further.

Within the data, we have identified three categories of True Venture businesses:

- Rising to premium (mean and above) – this group represents about 24% to 29% of businesses in the cohort.
- Stretching the average (median to mean) – representing 26% to 21% of businesses.
- Battling to the middle (0 to median) – the core of this group, representing 50% of businesses.

So, is there hope for would-be True Venture entrepreneurs?

We think so, and below are our top tips for those entrepreneurs considering raising funding:

01

Be realistic – there are only 114 True Venture deals per quarter on average, therefore there is a significant chance that you may not be successful first time round. Adequate preparation of your value creation strategy (i.e., how you are going to create a very realistic exit for shareholders that provides them with strong returns), underpinned by a robust and data-based financial forecast, supported by strong live unit-economics and a forecast capitalisation table that enables investors to see expected share price growth, further funding requirements and a range of expected exit values should significantly improve your chances. Typically, investors will want to know you are ready to both sell and deliver at scale; many will often want to see you already at a run rate revenue of £1m or £2m with good margins. We have a recording that shares our experience on what businesses need in order to raise funding here.

02

Avoid jealously – just because a peer has raised capital, it doesn't always mean others can. Try not to compare yourself to peer businesses on the basis of headline figures – find out the detail behind the deal including deal terms, business performance at the time of the deal and the state of the external environment at the time of raising to understand the conditions that determined their success. We have another guide on valuation that explains how growth valuations often skew reality.

03

Talk to your angels about further re-investment to start the round (as per the ordinal data, you will already have them), and they should know it is coming with a proper funding road map and be able to understand their diluted returns in different exit scenarios.

So, is there hope for would-be True Venture entrepreneurs?

We think so, and below are our top tips for those entrepreneurs considering raising funding:

04

Build critical mass in your team funded first by profits, angels/small funds/crowd/debt and R&D tax credits.

05

Product/market fit is key – this is having the right product, at the right time, for the right market, at the right price, sold in the right way. If a company has it there is an unquantifiable factor that speeds sales, increases stickiness and drives growth. This is what growth capital investors are looking for and all good investors and advisors will have their own litmus test to test fit. It is not easy to get data to demonstrate this point, but in our experience, this is what drives True Venture success. You can hear more about Product/market fit here.

06

Market/product + Team wins. Simply, if you have fit along with a world class management team who are humble, want to learn and who can collectively innovate, market, sell, lead and deliver operationally, then a company will succeed. Beyond the data, this is what we think underpins being a premium True Venture business.

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