



10 DOWNING STREET

THE PRIME MINISTER

17 September 1983

Dear Dr. Cooksey,

Thank you again for your first-rate contribution to the Seminar on Science, Technology and Industry at Lancaster House on Monday.

Your paper was not only valuable in itself but also for the way it stimulated other contributions from the floor. Many thanks for all the work you put into it.

I thought the day a success and I shall be giving thought to how we can follow it up in a suitable way. If you have any views on the follow up, I would be delighted to hear them.

Yours sincerely

Margaret Thatcher

Dr. D.J.S. Cooksey

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19 August 1983

Timothy Flesher Esq.,
Private Secretary,
10 Downing Street,
London, SW1

Dear Mr Flesher

Thank you very much for your letter of 9 August inviting me to participate in the Seminar on "Science, Technology and Industry" on September 12. I have great pleasure in accepting that invitation.

As requested I will submit a copy of my paper for inclusion in the press briefing material not later than 5 p.m. on Thursday 8 September.

Your sincerely
David Cooksey

D J S Cooksey

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USE ON CLUB TAPES BEFORE ¹²⁻³⁰ hrs. ⁰¹...

FINANCE FOR INNOVATION

12-9-83

By David J S Cooksey
Advent Limited

Several years ago there was much debate in this country concerning the availability of finance for small innovative companies. You would often hear the statement "There's too much money chasing too few good projects". The emergence of the venture capital industry over the last three years has shown that there was a financing gap. In particular those who were most worthy of investment were often unable to obtain finance on the right terms. The fund manager and banker were looking for early returns on what should be a very long term investment. The bulk of such financing was based on secured loans which were the wrong basis on which to start high risk technology driven enterprises. If we are to create fast growing enterprises then financing with the brakes off, true equity financing is vital. It is the core of the explosion of growth in new high technology companies in the United States.

The returns from high technology will come by realising capital gains not from annual running income. The classic example of this is the Digital Equipment Company, formed in Massachusetts, with venture capital over 25 years ago and which has never paid a dividend. Yet it has been an outstanding investment for those who ventured their money in it because of the massive capital gains they have realised.

The reason why too much money was chasing too few good projects was because only rarely did an investment proposal combine exceptional innovation with management talent. Too often it was the scientist pedalling his invention with little understanding of the marketing, manufacturing and financial performance needed to create a business success. Inventors and trained business managers rarely came forward together because the latter had no incentive to risk their careers in new ventures. The risk was too high and the reward too low - particularly after the tax man had had his massive bite.

The role of venture capital is to provide long term patient investment for technology driven enterprises. Since technology changes rapidly products must be exploited quickly in the marketplace. Therefore the size of investment and level of risk are considerably higher than in more traditional businesses. On the other hand successful investment can create a large international business in a relatively short timescale. And in successful brain based industries the total investment is often small compared with the returns generated.

Venture capital directs the majority of its funds into equity investment in unquoted private companies where there is an identifiable product which is ready to be brought to market. Investment will take place at any time between this "greenfields" situation and the last round of financing prior to a public

offering of the company. There are over 30 venture capital companies in the United Kingdom with resources of about £200 million, of which perhaps half is now invested. All of those those funds are inundated with proposals for financing. The proposals are of very variable quality.

The success of venture capital will depend on the availability of good management to work with the technologist to create these future businesses. Government can, and I hope will, act to improve the conditions for growth, namely the flow of funds to the venture capitalist and the flow of able management into entrepreneurial enterprises.

As I have said, venture capital can satisfy the financing requirements of an identifiable business. It will not fund research and development which will not readily develop into a business within two to three years. Therefore there is a major role for government or its agencies such as NRDC to play particularly in the area of funding early product development. Such government support of development is vital in the period between research discovery and the time that the venture capitalists can recognise a business to invest in. I hope that BTG will be encouraged to concentrate on this role. It is an area where BTG and the venture capitalists can work productively together not only to ensure business creation but also to avoid wasteful expenditure on applied research.

The venture capitalist is distinguished from the institutional financier by his "value-added" approach to his investments. The venture capitalist is looking for investments which will have market differentiation due to their technological lead or their ability to assert a dominant position in a particular market. He will look for proprietary protection of the technology - either through patents or an ability in the management team to stay ahead of the competition. He will look for products which command high margins which are vital to fuel the growth of the company and pay for the inevitable growth of R & D and marketing expenses as products age. Above all, he will look for a management team, which is present or can readily be acquired, to grow a substantial company in an exceptionally short time scale. He must also know that he will be able to realise his capital gain in due course.

The venture capitalist spends much of his time analysing the opportunities and problems facing each company prior to making an investment. He researches and seeks advice concerning the markets and financial projections of the company and the technological strengths of the products involved. He knows that he will rarely find satisfactory answers to all of his questions. He is usually prepared to devote much energy to the company concerned before, during and after the investment is made to improve the marketing technological, financial and above all management capability of the company concerned. As a result he looks for an exceptional level of return in realised capital gains from the investment.

History in the United States has shown that this investment process succeeds and has been the seedcorn of many of today's great American enterprises. It is easy to point to the massive homogenous United States market and claim that life is made easy for the US company. It is true that it is easier for such a company to grow quickly in the U.S. since 50% of the world market for technology based products normally exists in the U.S. The figure here in Britain is more likely to be 5%. It is therefore vital that British companies which are to compete successfully with technology based products must address the US market (and Europe too) very early in their activities. This increases the level of funding required and the level of risk involved, but it also increases the opportunities enormously.

At Advent we have specialised in backing companies that are prepared to take this international approach to their markets and we have put people on the ground in the United States and Europe specifically to assist our companies to achieve rapid market penetration outside the U.K. I would like to examine some examples.

Multispec is a company, based in York, making infra red analysis instruments for quality control in the milk and dairy products industries. It has grown in sales from £720,000 in 1981 to £2 million in 1983 and from profits of £75,000 in 1981 to £800,000 in 1983. It exports 90% of its instruments in particular to the USA and Japan. Total funding of £400,000 was injected by Advent two years ago. This company will continue to grow as it extends its technology into quality control products for the oil and pharmaceutical industries.

Xenotron is a supplier of graphics terminals and associated software to the printing industry. It was started in 1976 in Diss, Norfolk based on computing expertise from Cambridge. Two years ago Advent and another venture capital company invested £500,000 in Xenotron when sales were about £1.5 million. The company now exports to the USA, Europe and Australia in excess of 50% of its products. Its sales will be £5,500,000 in 1983 and its profit before tax should exceed £700,000.

Enterprise is a computer company located south west of London supplying real time trading systems for selling advertising time on commercial television. It supplies its service to 13 of the 15 commercial television companies in the UK. Sales in the year to 31 March 1983 were about £3.5 million. Advent has invested £1 million in the company to enable it to bid for the business of the US TV networks. The company is close to its first contract in the United States. This will enable the company to grow several fold and to sell British software into an American market from which we would expect to be the receiver not the producer of technology.

Finally, I turn to a company called Filtronics. It is the classic university spinout with a team of microwave engineers from Leeds University led by their professor. He set up a

company to exploit their exceptional capability in the field of microwave filters. They are deeply involved in electronic intelligence gathering and in electronic counter measures devices.

Filtronics was funded as a virtual start up two years ago with £0.5 million from Advent. Since then we have injected a further £1.5 million as well as raising £3.8 million for expansion in the United States. Whilst today the companies have sales of less than £3 million per annum we now know that they will receive orders from both sides of the Atlantic amounting to many £million's over the next few years. A large proportion of that business will be manufactured here in the U.K. For Advent it has been a very high risk investment involving an enormous amount of work and heartache - but one which will create a substantial business here in the UK based on a dominant British technology. Historically that business would have ended with a licensing deal whereby our team in Leeds would have received a miniscule royalty flow for a few years from a large US defence contractor. Instead we have created a British business with enormous potential.

Advent has raised £20 million for investment in UK ventures. It now has about 25 investments totalling over £10 million. I have mentioned some examples and there are several more that are giving us cause for excitement. Inevitably there are some that will fail, that is the nature of our business.

We have been encouraged by the relationship we have built up with entrepreneurs and with the Universities as a source of innovation and advice. But that is not enough since it is vital that good managers should come out of larger companies to participate in the formation and growth of venture capital backed companies. The improved quality of the proposals coming to us indicates that this has begun to happen.

The flow of able management would increase dramatically if Government would take steps to ensure that they would have the right to take the full value of their pensions with them from previous employment and that they could participate in share options in the companies they join. It is vital that the benefit of those options is not considered as ordinary income but as capital growth since they must be given the benefit of growing the capital worth of their companies.

A further inhibition to venture capital activity is the need for the venture capitalist to seek his own funds from the tax privileged institutional funds. Since venture capital funds receive no such tax privileges they have to persuade the institutional fund manager to accept taxation on capital gains that he would avoid by direct investment himself. The institutional manager, who dislikes long term non yielding investment anyway, is finally put off investing by the prospect of being taxed on capital gains unnecessarily. He prefers to stay with gilt edged stocks and property.

The result of this is that venture capital funds are being formed offshore often funded with overseas money. This is unfortunate and could easily be remedied by giving the venture capital funds the same tax treatment as investment trusts, namely to remove them from liability to capital gains tax.

In conclusion, we have a capability in this country to design technology based products which can command high profit margins because of their innovative character. It is those products which will fuel growth in the economy and improve standards of living. The venture capital industry will seek to help exploit the best of innovation that comes from the universities, from government and private research laboratories and as spin outs from larger companies. Given a stable and improving climate for this activity the results will begin to show shortly in terms of competitive new products which will create wealth for the nation and real new jobs.