Out of the chrysalis

Investing in the UK's leading emerging companies

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Investec
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Out of the Ordinary

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Out of the chrysalis

It is an exciting time to invest in ambitious early stage and scale-up companies in the UK. London is now a top-three start-up ecosystem globally and attracting record levels of investment. Fintech, in particular, continues to attract substantial capital.

The growth of the UK market for emerging businesses – which we classify as those successfully out of seed stage and well positioned for rapid growth – has been supported by a mature ecosystem in London. This ecosystem leads the world in its combination of success factors: talent, infrastructure, access to capital, proximity to policy makers and global connectivity.

But it's also bolstered by a large domestic market – and more than one thousand co-working and incubation spaces. Since 2011, more than 7,600 start-ups have been created in London's "Tech City" cluster alone.[1]

So we see considerable opportunities in London to invest in late seed and scale-up funding rounds (Series A and B) for the foreseeable future. Valuations for these businesses remain comparatively well calibrated to motivate ambitious entrepreneurs and provide value for investors. And the scarcity of capital creates significant opportunities for committed investors.

That doesn't mean it's easy. In order to increase the chances of success, investors should bring subject expertise, experience of backing businesses at start-up and scale-up stages, and knowledge of what drives success in sectors such as fintech. Smart deal sourcing, enhanced due diligence and diversification are must-haves. Commitment to follow-on rounds and active portfolio management are critical to balancing risk and reward.

Investors should take comfort in the widening pool of options for realising value, which include public listings and M&A by global technology companies.

In short, then, the UK's emerging companies represent a compelling investment opportunity for serious investors looking for exposure to the latest technologies.

Kevin Chong and Devin Kohli,
Co-Heads, Emerging Companies UK/EU at Investec

Stellar growth

Rapid fundraisings and follow-on investor enthusiasm have marked out UK fintech as a global scale up hot-spot.

Market overview

The UK continues to be a very attractive market for ambitious companies and scale-ups to access growth funds. Apart from a brief pause around the Brexit referendum in 2016, UK tech firms have attracted record funding in each of the past five years. In 2017, the year following the Brexit vote, UK tech firms raised close to £3bn from venture capital, twice that raised in 2016.[2]

In terms of raising scale-up funding between £5m and £10m in 2017 across all sectors, 188 UK companies attracted investment.[3]

The amount of funds invested in UK fintechs is outpacing the rest of Europe, with London attracting five times the amount of its closest European city competitor. Globally, only New York, Beijing and San Francisco have raised more capital for fintech over the past five years.[4]

Late-seed and series A activity is supported by active follow-on rounds. In the past year, more than 30 UK start-ups have closed fundraising in excess of £50m, with the total amount invested nearly £5bn. This figure is higher than the previous three years combined.[5]

There are now 19 UK-based tech companies with a valuation of more than £1bn. The success stories are compelling.[6]

Deliveroo, for example, raised £300m in new funding in 2017, valuing it at over $1.5bn, despite being formed only in 2013.[7]

And Improbable, an enterprise software start-up that builds virtual worlds, raised £390m, the largest ever round of venture capital funding for a private British company.[8]

But fintech has dominated the headlines for raises in excess of £50m in 2017.

Only New York, Beijing and San Francisco have raised more money than London for fintech over the past five years

*Source for specific round data: **Crunchbase***

UK FINTECH RAISED OVER £1.3BN IN 2017

FUNDING CIRCLE
£78M SERIES F
SERIES A, 2011 = £1.9M

MONZO
£90M SERIES D AND E
SERIES A, 2015 = £5M

REVOLUT
£51M IN 2017
2ND SEED IN 2016 = £1.7M

TRANSFERWISE
£217M SERIES E
SERIES A, 2013 = £4.7M

• Picking the winners

While fintech continues to present strong investor interest and disruptive potential, it's not the only game in town.

Sector Focus

Investment in fintech is set to continue with the introduction at the start of 2018 of Open Banking via the EU's Second Payment Services Directive (PSD2) and new Competition and Markets Authority regulations.

This is a once-in-a-generation change, building on existing technology disruption in financial services, which will shift the value chain between customers and banks. For the first time, consumers and businesses will be able to take control of the personal and transactional financial data held by their banks. That's creating huge opportunities for insurgents with new business models and tech.

Similar disruptive forces are opening opportunities outside fintech, in enterprise software, artificial intelligence (AI), online/offline retail, cyber security and healthcare.

Sectors that have large international addressable markets (of at least £1bn) and low customer satisfaction (insurance is a notable example), and that are ripe for fundamental technology improvement, are generating interesting VC opportunities.

Blockchain has the potential to disrupt a wide range of sectors (including VC itself) and is likely to generate interesting investment opportunities – but must also be treated with realism, particularly around regulatory challenges.

Exit Options

Investment is buoyed by the diversity of exit options for high-growth companies. After a more-than-solid 2017, many analysts are predicting a bumper year for tech IPOs in 2018. "With the market at all-time highs, valuations are at the high end, presenting a favourable backdrop for IPOs," NASDAQ president Nelson Griggs told Reuters in December.[9]

In London, 2017 saw over 106 IPOs, an increase of 63%, with more than £15bn raised.[10] The UK markets have a strong pedigree here. For example, Zoopla, a property listing portal, went public in 2014, just six years after being founded, valuing the business at £919m.[11] (At the start of 2018, its market cap was £1.5bn.)[12]

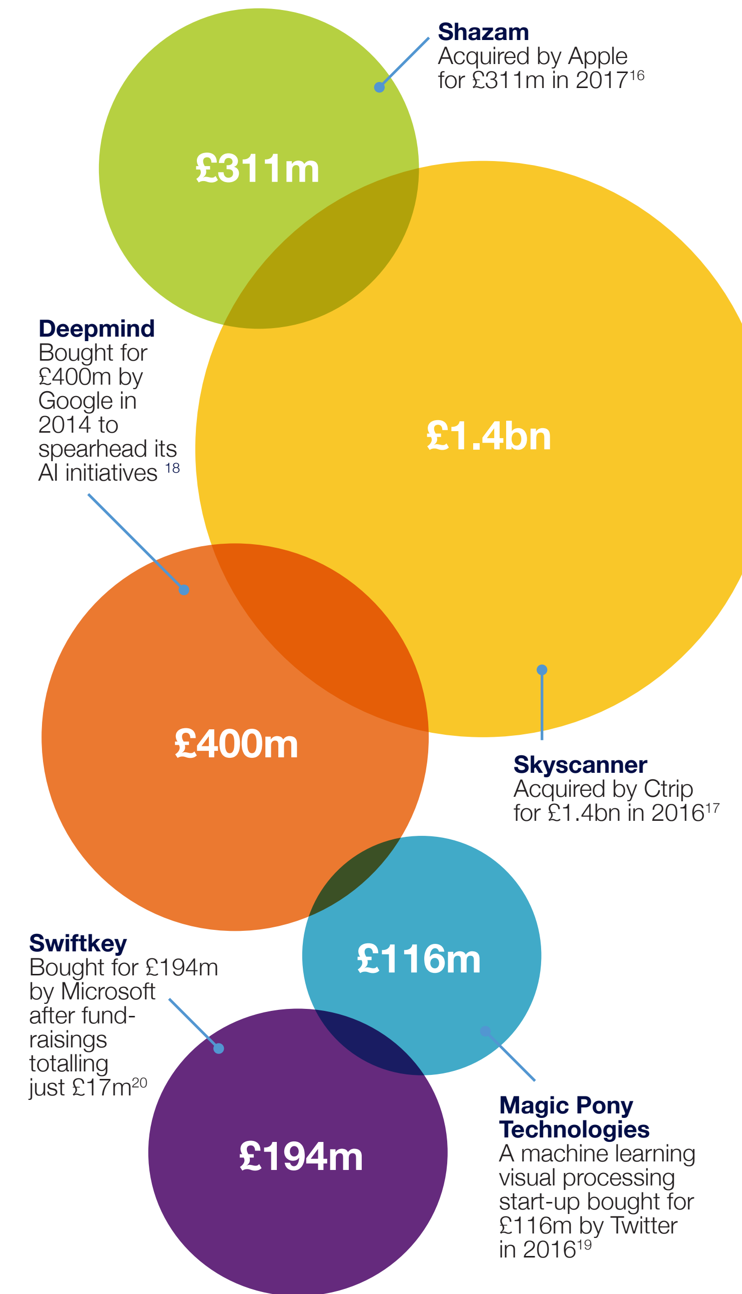
The junior markets have also been an attractive exit for emerging companies. For example, the market capitalisation of Blue Prism, a London-based robotic process automation business, has increased tenfold since its IPO in 2016.[13] (Note: Investec was the adviser and sole book runner for the Blue Prism IPO.)

Investors across the board have shown an appetite for exposure to these businesses, creating some interesting secondary deal opportunities to crystallise value in emerging company investments.

For instance, Draper Esprit, a European venture fund listed on AIM, raised more than £160m during 2017 for early stage investment.[14] It purchased early stage investor Seedcamp's first two funds in the last quarter of 2017. The £18.3m Draper Esprit deal represented a 400% return for Seedcamp limited partners (LPs).[15]

Active IPO and secondaries markets are complemented by M&A activity (see chart, right, for more examples) – often by banks (buying fintech firms) and from US technology majors acquiring leading UK companies in order to retain their competitiveness.

Scale up to acquisition target

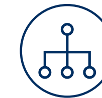


See also...
Wealthify, which attracted a majority holding from Aviva in October 2017[21]
Nostrum Group, bought by Equiniti in July 2017[22]

The PwC *Global FinTech Report 2017* revealed that about 50% of financial services firms globally plan to acquire fintech start-ups in the next three to five years.

Why focus on the UK when backing start-ups?

Simple: the building blocks for success are all in place.



Government

Government policy in the UK has helped to foster an ecosystem that helps facilitate the creation of innovative high growth companies, underpinned by access to capital.

SEIS, EIS and VCTs are all highly tax-efficient schemes that help de-risk seed investment into early stage companies by UK taxpayers. These are likely to prove to be an even more fruitful source of capital for entrepreneurs due to the Government increasing their threshold limits in the 2017 Budget.[23] This is a world-leading initiative and a vital component of the UK start-up ecosystem.

These schemes are supplemented by the British Business Bank, which supplies capital and credit to SMEs. One of its responsibilities is to distribute £2.5bn of additional "patient capital" to scale-up companies.[24]

Entrepreneurs are also incentivised to create intellectual property by a generous R&D allowance for qualifying expenditure.

SEIS, EIS and VCTs are all highly tax-efficient schemes that help de-risk seed investment into early stage companies by UK taxpayers

"London, with its unmatched proximity to finance, politics, public intellectuals and top universities, is the best place to create start-ups that want to scale fast to become world class"

Alex Lightman, author of *Brave New Unwired World* and *Augmented: Life in the Smart Lane*, entrepreneur and futurist

Universities

Being host to some of the top universities in the world is another start-up and scale-up accelerant. Imperial, Oxford and Cambridge are in the global top 10 universities[25] and, together with UCL, lead the world in artificial intelligence and machine-learning research.

The DeepMind deal exemplified this attraction. A developer of AI technologies, it was acquired by Google for £400m in 2014, on condition of retaining its UK base.[26] This has allowed them to continue to attract the best PhDs from Oxbridge and UCL, and means that the UK will be at the forefront of developing practical AI expertise for years to come.

"[DeepMind] really is the biggest collection of brainpower anywhere in the world on this topic, and it's happening right here in Kings Cross," Demis Hassabis, Founder & CEO of DeepMind.[27]

The AI Readiness Index, compiled in 2017 by consultancy Oxford Insights, ranked the UK first out of the world's 35 most advanced countries. "But it is important for the UK to stay ahead by supporting AI research, technologies and companies," warned Oxford Insights CEO Richard Stirling.[28]

International

The London ecosystem is a pull for global corporations and start-ups alike. In a sign of post-Brexit confidence, Google last year announced a new 92,000-square metre, £1bn "landscraper" building that will house 7,000 employees.[29] Facebook's new London office will be its largest engineering hub outside of Silicon Valley.[30]

Just Eat, Europe's largest online takeaway food company, started in Denmark but soon headquartered in the UK to meet its growth ambitions. It went from a series A funding round of £5m in 2009 to IPO in 2014 valued at £1.5bn to FTSE status in 2017.[31]

It's not all one-way traffic. London's Entrepreneur First, a leading UK-based accelerator with a unique pre-team model, is about to celebrate the second anniversary of its Singapore offshoot.[32]

Just Eat, Europe's largest takeaway food company, moved its HQ to the UK to meet its growth ambitions

The UK VC landscape

An active ecosystem of start-ups, scale-ups, international players and financial institutions makes the UK an attractive option for investors.

Seed

Companies raising money at this stage (rounds of up to £500,000) are unlikely to have gained much traction in their marketplace – perhaps they have a beta product or are seeking market fit to prove demand and scalability as they build out their revenues.

Early stage investments tend to be made by accelerators, syndicates of private investors benefitting from UK tax incentives and crowdfunding platforms – and tend to be high risk. The strategy is to spread the number of investments in order to maximise their chances of identifying a star performer out of a large number of investee businesses.

There has been a slowdown in the growth of investment at seed stage in recent years

Crowdfunding is an increasingly common way for these companies (particularly retail/consumer businesses) to close rounds, as well as an effective means of reaching a new customer base. There has been a slowdown in the growth of investment at seed stage in recent years, which we view as a positive indication of ecosystem maturity and recalibration of valuations.

"Post seed"

At this stage, businesses have found some product/market fit and are looking to make key hires and execute on well developed business plans. The "post-seed" round (£500,000 to £1.5m) is beyond the capacity of typical seed investors. Yet larger institutional VCs tend not to write cheques for less than £5m. Investment into "late seed" stage grew rapidly in the years leading up to 2016. But there has been a discernible slowdown in the growth of funding at this stage during 2016 and 2017.[33]

That's done nothing to address the much-discussed funding gap between seed and Series A rounds – where many businesses are highly investable, but where capital is scarce.

The data shows that valuations at this stage have stabilised, particularly in comparison with the Series A+ stages where valuations have been steadily increasing in recent years as VC funds have been growing bigger and driven to focus on later, larger funding rounds.

VC funds have been growing bigger [of late] and driven to focus on later, larger funding rounds

Competition is a factor contributing to the increase in valuations for Series A raises

Series A

Series A rounds (usually £5m to £10m) have seen increasing activity in recent years. The total amount of UK Series A investment rose 24% from 2016 to 2017.[34]

Corporate and strategic VCs have also been showing increasing interest at this level, and the competition is a factor contributing to the increase in valuations for Series A raises.

But it's not uncommon to see crowdfunding and other alternative finance options used at this level to augment a cornerstone investor. Monzo, a challenger bank, raised a £6m Series A round in 2016; £5m came from Passion Capital and the remaining £1m was raised on Crowdcube, the UK's largest equity crowdfunding platform.[35]

Illuminating the Opportunities

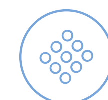
For inexperienced investors or those without sector knowledge, investing in start-ups can be daunting. There are ways to manage the risk and rewards.

Filling the gap

Investing in emerging companies is the archetypal risk-management exercise. Earlier investment can yield much higher returns, but also increases the chances of taking a stake in companies that won't make it.

Late seed stage companies can present attractive opportunities at the right valuations. The slowdown in growth of funding at the late seed stage in the past two years could lead to a healthy recalibration of valuations and enhance the quality of deal opportunities.

Investors should focus on companies that have the potential to dominate or create a new category. Naturally, a solid approach to both market and investee company due diligence remains a must. Proper evaluation of the opportunity, management team, business model and financials remains central to any decision to invest.



Diversification

Deploying capital across a well-diversified portfolio of companies will help manage risk, as well as increasing the odds of picking future stars.

In a mature ecosystem (such as London), best practice should involve sourcing and reviewing 1,000 to 1,500 opportunities each year and building a portfolio of 30 to 35 companies.

Early stage companies and their founders can benefit greatly from experienced investors on the board, who can help position their company

Capacity to follow-on

In venture capital, reserving capacity to engage in follow-on investments is essential to protect against dilution and to maximise return from the "winners" in a portfolio. Reserving capacity to invest also ensures that an investor continues to be relevant and influential as the company grows.

Portfolio management

In addition to diversification and reserving capacity to follow-on, early stage investing requires active portfolio management.

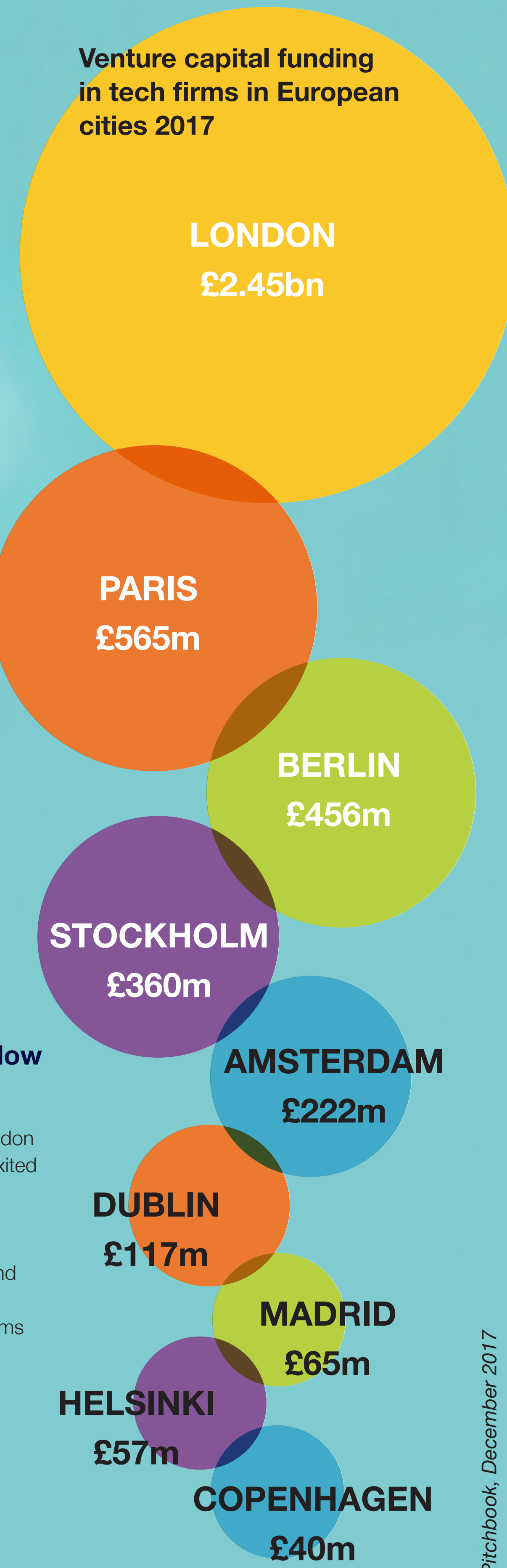
As the range of investors (strategic funds, corporates and large VCs) grows, investors should build and maintain relationships across the range to maximise co-investment opportunities and exit options. This should be an important element of portfolio management.

Being an active investor, by taking a seat on the board, is a crucial way of growing value and supporting portfolio companies. This allows investors to have a material influence on the future success of companies, gain access to founders and stay abreast of both market and deal-doing opportunities.

Early stage companies and their founders can benefit greatly from having experienced investors on the board, who can assist with positioning the company for the next round of fundraising or exit if appropriate.

Leading lights

Taking advantage of comprehensive expertise in the emerging technology markets, Investec launches a new venture investment fund offering access to Europe's leading start-ups



Investec Emerging Companies UK

Offering clear-eyed, diversified exposure to UK technology start-ups

Investec Emerging Companies UK is launching a venture investment fund (INVC) as a key part of Investec's venture offering for clients, with similar funds launching in India, Israel and Australia. INVC is a £75m fund offering a disciplined, diversified and value-oriented opportunity to gain access to one of the world's leading start-up ecosystems.

Based in London, the fund will be at the heart of one of the world's most active, diverse and creative centres for technology and especially fin tech start-ups and scale-up businesses.

INVC's investment deal flow sources include:

- Comprehensive coverage of accelerators and incubators in London
- Proprietary network of founders, exited entrepreneurs and co-investors
- International network of top-tier technology clients
- Relationships with private equity and venture capital investors
- Investec Emerging Companies teams based in Cape Town, Hong Kong, London, Mumbai, and Sydney

INVC is open to select clients.

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Contact us

We're here to help. To find out more about the Investec Emerging Companies fund, get in touch:

Kevin Chong
kevin.chong@investec.co.uk
+44 (0)20 7597 5203

Devin Kohli
devin.kohli@investec.co.uk
+44 (0)20 597 5158

investec.com/emergingcompanies

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