THE ROYAL SOCIETY OF EDINBURGH

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ROYAL SOCIETY OF EDINBURGH
BUSINESS INNOVATION FORUM

The Financing of Business Innovation in Scotland

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Contents:

Executive Summary

This report presents the outcomes and conclusions of a consultation process undertaken by the Royal Society of Edinburgh's Business Innovation Forum on the topics of the financing of innovation in Scottish companies and the aspects and characteristics of the current financial environment which support or constrain businesses seeking to grow and develop in Scotland.

The initial stage of the consultation process, undertaken during the first and second quarters of 2012, involved a series of interviews with informed commentators representing a diverse range of backgrounds and interests, including the business angel community, the venture capital sector, commercial banks, corporate finance advisers and companies with recent or current experience of seeking development funding. The experience of the interview programme suggested that it would be productive to arrange a workshop event to bring together representatives of these constituencies and enable interchange of views and experience. The substantial body of information, comment and opinion offered by those interviewed provided the basis for the production of a discussion paper as a means of setting the scene and providing a framework for this workshop event, which was held in the Royal Society of Edinburgh on 31st May 2012. This document presents both the discussion paper and a report on the proceedings of the workshop, as well as a number of principal recommendations emerging from the consultation process.

The discussion paper (Part 1 of this document) briefly sets a context in terms of the current economic and financial background and refers to the perception and quantification of risk as an issue in funding industrial innovation. It then deals with the topic of equity funding in the forms of venture capital (VC) investment and informal (ie. business angel) investment, summarising aspects of the historical development, present status and scale and the operating characteristics of both the VC and business angel communities. Reference is also made to Scotland's important institutional investment sector and its historically limited interaction with indigenous non-financial businesses. Scotland's track record of commercialising emerging technologies to significant scale is considered as a factor in attracting investment, whether through indigenous or international channels.

Addressing the topic of debt finance, the paper outlines the present situation and role of the commercial banks, and refers to the role of public sector debt funding and to the recent emergence of other non-bank debt funding mechanisms. Finally, the present environment is considered from the perspective of emerging companies seeking funding for innovation and growth. Six discussion topics, covering key emerging issues, are presented as a basis for the agenda for the workshop event.

The report on the workshop (Part 2 of this document) summarises the discussion which took place under each topic heading. The principal themes were:

- The potential for increasing productive interaction between the institutional investment community and indigenous non-financial businesses.
- Increasing engagement with non-indigenous venture capital investors.
- Achieving greater alignment of the interests of business angel investors, venture capital investors and the companies in which they invest.
- The future strategic role of public funding in equity investment.
- The role of debt funding in the growth of smaller companies and the practicalities of improving their access to debt funding.
- The extent to which the Scottish environment and infrastructure support effective mobilisation and application of entrepreneurial talent and energy.

The report on the workshop includes an annex presenting a number of specific suggestions put forward by participants in light of the discussion which took place and on the basis of their own experience and insights.

Part 3 of this document sets out the RSE Business Innovation Forum's three principal recommendations based on its work in this area. These are:

- That a senior level advisory group should be established to investigate and report on the feasibility of mobilising new sources of risk capital in Scotland.
- That the infrastructure available to support Scottish companies in connecting with sources of equity investment outside Scotland should be reviewed.
- That an evaluation should be undertaken of the potential for and feasibility of creating (a) new vehicle(s) to provide access to loan funding for emerging Scottish companies on terms which would be viable for the businesses and acceptable to the lenders.

Part 1

DISCUSSION PAPER - MAY 2012

1.1. Introduction

We live in a time of great economic challenges. Political discourse in the UK and across Europe has polarised around the themes of "austerity" and "growth" – ie. whether the primary priority in responding to a large and increasing national debt should be the reduction of public expenditure or the stimulation of economic growth. In the main, this debate tends to be characterised by differences of views on policy on and impacts of public expenditure – the most readily accessible lever available to a government seeking to stimulate economic growth.

There has, until recently, been less high profile public debate about the role of the corporate sector in generating economic growth. This may be because the capacity of governments to influence the achievement of private sector-led growth depends on measures which are less direct, more complex and arguably less predictable in outcome than policy on public expenditure. Nonetheless, private sector-led growth is in the long term the only sustainable route towards breaking the current dilemma.

A recent ITEM Club report [1] commented, "As a nation we have been living beyond our means and need to adjust." The dynamism and competitiveness of our corporate base lies at the heart of our capacity to make this adjustment, to begin to reduce national indebtedness and ultimately to sustain the prosperity of future generations. This places businesses of all sizes and types across Scotland and the rest of the UK in the forefront of a fight for economic wellbeing and the maintenance of anything like the national and personal standards of living to which we have become accustomed. The ability of our companies to grow and develop, to compete effectively in domestic and international markets and to realise their full potential has always been important; arguably, though, it has never in living memory been as critical as it is now and will be for the foreseeable future.

1.2. Innovation and risk

The financing of innovation, and, by extension, of company growth and development, involves by definition the provision of resources to achieve what has not yet been achieved. Inherent in any such endeavour are uncertainties as to the outcome. These uncertainties may range from being limited, definable and controllable to being multi-faceted, unquantifiable and unforeseeable. Their position on this spectrum determines the level of risk perceived by those providing resources.

The fundamental dynamics of financing innovation revolve around achieving a balance between risk and return which is considered acceptable by all the parties involved. This applies in all situations and (albeit in varying ways) to all sources of funding – equity or debt, private or public.

1.3. Equity investment

1.3.1. *Venture capital*

The venture capital (VC) industry internationally has for some years been facing significant challenges, the origins of which pre-date the banking crisis of 2008 and the current economic environment. The dot.com bubble of the late 1990s drove an increase in VC activity, a considerable amount of which involved investment characterised more by a goldrush mentality than by the exercise of rigorous critical evaluation. As VC funds are generally managed to return capital to their partners within a ten-year period, the consequences of the "irrational exuberance" of the dot.com era manifested themselves during the mid and later part of the 2000s. The returns for investors in VC funds have in the main been poor in recent years, to the point that the perception by institutional investors of VC as an asset class has been considerably damaged. Reflecting this, their propensity to place funds under VC management was beginning to decline even before 2008, and the environment since then has reinforced this trend.

It is also widely recognised that through the 1990s and 2000s, the focus of much of the private equity sector in the UK shifted away from the provision of genuine risk capital to support the medium- and longer-term growth and development of high-potential businesses. There was an increasing preoccupation with "financial engineering" designed to extract short-term returns from existing companies.

One consequence of the collapse of the dot.com bubble was the virtually complete withdrawal of the venture capital community from seed stage investment. Driven by considerations of risk and transaction cost, the minimum level of investment rose, typically, to the order of several million pounds. It has also become almost universal practice for VC investors to require liquidation preferences specifying that on an exit event their investment (and sometimes a multiple of their investment) is returned before any distribution of proceeds to other shareholders.

Scotland's indigenous VC community is small, but it is notable that even against the background outlined above, it has continued to demonstrate the ability to raise new funds. Panoramic Growth Equity, Scottish Equity Partners and Clyde Blowers Capital have all launched new funds within the past year or so. The fact that a VC house is based in Scotland, however, does not represent any guarantee that it will be predisposed to make investments in Scottish companies. The approach will invariably be to seek the highest quality deals across a wider geography. In some cases (eg. where a fund includes money from the UK Government's Enterprise Capital Fund) a UK-wide geographic limitation may apply, but otherwise the only geographic restriction is that imposed by the limitation of management costs to an acceptable level.

There has for many years been a widely-held perception that throughout the world, VC investment tends to be a fairly localised activity. Investors, it used to be said, wanted their portfolio companies to be no more than a short journey (typically around an hour) away from their offices. This may originally have been a reflection of the concentration of investors and investment opportunities within a limited area in Silicon Valley. Whatever its origins, if it ever was a true reflection of reality, it seems to be rather less so now. A number of recent instances of interest and engagement in Scotland on the part of foreign investors have been reported. It would seem particularly important for Scotland to seek and cultivate such engagement in contexts in which the investment required to grow companies is substantial in scale and long-term in nature. This is relevant in certain sectors in which we are considered to have technological or natural strengths, eg. life sciences and renewable energy.

It is interesting to note that even commentators within the Scottish VC community refer to the desirability of having more players active in our venture capital market. This is perhaps not as counter-intuitive an observation as it might seem; syndication of investment between VC houses is common, and foreign investors considering making an investment in Scotland might well be expected to seek to participate in a syndicate including, and possibly led by, a Scottish house. The involvement of more non-indigenous investors might reasonably be expected to increase the overall diversity and dynamism of the venture capital market in Scotland.

Whilst more engagement with international investors may be desirable, it seems relevant also to reflect on the fact that the financial services sector is a significant element of the Scottish economy, employing over 90,000 people. It is estimated that Scottish financial institutions have around £750bn of funds under management[2], but reference is sometimes made to the tiny proportion of these funds believed to be invested in Scotland. There is an impression in some quarters that the locally-based institutional investment community perceives Scotland as a place from which to manage investments, not as a place in which to make them.

One recent development bringing an additional dimension to the overall picture has been the establishment of the UK Business Growth Fund (BGF). BGF, launched in May 2011, is an equity fund owned jointly by five banks (Barclays, HSBC, Lloyds Banking Group, Royal Bank of Scotland and Standard Chartered), and has been presented as one of a series of initiatives designed to improve working relationships between the banking sector and UK businesses. The banks involved have committed an overall total of £2.5bn to BGF, which now claims to be the largest long-term equity investment company in the UK[3]. It is targeting the larger end of the SME sector, aiming to make investments of between £2m and £10m in established companies with existing turnover in the range of £5m to £100m. It has opened five offices, one of them in Edinburgh, and during early 2012 announced its first two investments in Scotland (one of £7.8M and one of £3.85m).

As well as considering the supply side of the growth equity equation, it is important to focus on the demand side. The development and vibrancy of the market for growth equity in Scotland depends fundamentally on its capacity to generate high-quality investment propositions. The extent to which such propositions are capable of competing for and attracting attention outside its own borders will determine Scotland's ability to raise its profile internationally as a place where high-quality investment opportunities may be found. In the technology arena, the Scottish research base is demonstrably capable of producing outputs of global significance, but we have a less convincing record of commercialising these at the speed and scale necessary to translate them into internationally compelling investment propositions.

1.3.2. *Informal investment*

The informal investment or business angel community in Scotland is amongst the most highly developed and structured in Europe. It is credited with having come to the rescue in the early-stage risk capital market in the aftermath of the dot.com bubble, when the venture capital industry withdrew from smaller-scale investment.

There has been a progressive transition over the past ten or fifteen years from an environment in which individuals or small groups made investments based on personal contact with entrepreneurs to a much more organised and less informal infrastructure. The majority of angel investment is now undertaken by managed syndicates, typically ranging in size from a few dozen to around a hundred individuals. Processes and procedures vary between syndicates, but typically involve preliminary evaluation of investment opportunities by an investment manager or "gatekeeper". Selected companies are invited to present to a panel or board of syndicate members, whose decision will determine whether the opportunity is exposed to the wider syndicate membership.

This evolution has enabled the angel community in Scotland to increase significantly the scale of its activity. Fifteen years ago, a company might realistically have sought up to a few hundred thousand pounds of early-stage risk capital from angel investors. Now, the larger syndicates will consider situations which are expected to require investment up to the order of two to three million pounds over several years. It is normal for such investments to be subscribed over a number of rounds, contingent upon the achievement of specified milestones on the company's development and growth path.

A major factor in the development of angel investment in Scotland has been the existence of the Co-investment Fund, launched by Scottish Enterprise in 2003 and now managed by the Scottish Investment Bank (SIB). This fund has significantly augmented the amount of funding available through angel syndicates. Its existence has had a significant catalytic impact on the number of active syndicates, which has increased from three or four when the Co-investment Fund was established to close to twenty now.

The Co-investment Fund increases the amount of early-stage risk capital available to companies in Scotland, currently by around 50%. The 2010/11 SIB annual review [4] indicated that its total investment during that year (of which only a proportion would be attributable to the Co-investment Fund) amounted to £23.2m, alongside a total of £53.7m of private investment, giving a public to private ratio of approximately 1 to 2.3. It has been suggested by some commentators that the Co-investment Fund may have some influence in convincing angel investors to make investments that they would not otherwise make. The impact of the Fund on the increasing quantum of investment funding is clear; its influence on attitudes to risk is less so.

One impact of the Co-investment Fund model that is perhaps less widely recognised is its influence on the relationship between angel syndicates and the companies in which they invest. As the lead investor, the syndicate's views and priorities tend to carry increased weight within their portfolio companies – becoming commensurate with the total amount of their own and the coinvestment.

The personal tax incentives available under the Enterprise Investment Scheme (EIS) represent a major driver of angel investment activity, allowing qualifying investments to be offset against income tax liability and shielded from capital gains tax liability. A new variant of the scheme, the Seed Enterprise Investment Scheme (SEIS), is being introduced in the current tax year, enhancing the tax incentives for investments in companies less than two years old. The EIS and SEIS concessions, designed to encourage high-risk investment in unquoted companies, are subject to a number of conditions and restrictions, including a provision that investors may only receive ordinary shares. Investments in shares carrying any liquidation preference are not eligible for EIS relief.

No source of comprehensive and reliable information on angel investment activity exists – it is possible only to make estimates based on partial data. In their 2009/10 annual review of UK business angel activity [5], Colin Mason and Richard Harrison reported that during that year, LINC Scotland members were involved in 78 investments, the collective value of which was £27.5m. £18.2 of this was angel investment, the majority of the balance presumably being public sector coinvestment.

The same report suggests, on the basis of a LINC estimate that its members become aware of around 35% of the angel deals undertaken in Scotland, that the total annual angel investment may be of the order of £50m. This would not seem inconsistent with estimates by Young Company Finance that the overall amount of equity investment (angel,VC and public sector co-investment) into unquoted Scottish companies is of the order of £100m per year [6]. This figure is believed to have remained broadly unchanged over the last five or six years.

The present economic situation has imposed a number of pressures on the angel investment community. Angel-backed companies in their early growth phases have tended to experience longer sales decision cycles on the part of corporate customers (at least in the UK), with consequent impacts on revenue streams and the time required to reach break-even. The withdrawal of the banks from lending to such companies has effectively closed access to funding from that source, increasing the need to finance working capital by equity investment. Exits for angel investors have been scarce for some years now, reducing the amount of capital potentially available for recycling into new investments. A number of commentators have referred to signs of "investor fatigue" beginning to emerge, and to an apparent recent reduction in investment available to new businesses, as investors allocate an increasing proportion of their available funding to supporting existing portfolio companies.

The increasing organisation and structure around angel investment has led to a progressively more analytical approach, with more attention being given to performance across syndicate portfolios. It has also led, particularly in the current environment, to a more intense focus on outcomes and timescales. It has been suggested that the preferred investment profile for an angel syndicate is now a company which will require total equity injection of about two million pounds, to enable it to reach a stage of maturity at which it can be sold within a period of about five to seven years, thereby allowing the investors to recycle capital and the entrepreneurs to move on to other ventures. This is, of course, the pattern for large numbers of angel-funded companies globally, and the "creation of wealth by entrepreneurial churn" is capable of significant economic impact. In some cases, however, it runs the risk of failing to realise the potential of major opportunities.

1.4. Debt Finance

1.4.1. *Banks*

Since the 2008 banking crisis, the relationship between commercial banks and their smaller corporate clients has altered significantly. The issue of bank lending to smaller companies has been the subject of extensive media coverage, the banking sector (particularly the banks now in substantial public ownership) having been publicly criticised by politicians and business organisations for a perceived withdrawal of support to the SME community. These banks themselves, whatever misjudgements may have occurred under past management regimes, face a present reality that presents a conflicting set of priorities – to rebuild their balance sheets and increase their capital ratios while servicing their own debt, to grow shareholder value and to respond to calls for increased corporate lending.

At the same time, the collective cash reserves being held by UK non-financial companies have been growing through the recession. A recent ITEM Club forecast [1] refers to holdings of currency and bank deposits having increased by £48bn in 2010 and a further £82bn in 2011, to reach a total of £754bn, around half of GDP. This reflects current economic uncertainty, probably related to a large extent to the Eurozone crisis, sapping confidence and causing commitments to investment and growth to be deferred in large companies and at the larger end of the SME spectrum. This situation must clearly be reflected in a reduction in the overall demand for bank lending. Bank of England statistics [7] indicate that the stock of lending to UK businesses has fallen every month since mid 2009, at annualised rates ranging from close to 10% in early 2010 to nearer 3% recently. It decreased by about £9bn during the three months to February 2012.

The regulatory environment in banking is also a major and increasingly significant factor influencing lending behaviour. Senior managers in corporate banking refer to the increasingly structured and rigorous risk analysis processes within which they have to operate. The lending criteria applied have increasingly had the effect of excluding emerging growth companies from access to bank funding.

Commercial banks have never (at least in their mainstream corporate banking activities) considered themselves providers of risk capital. Their business is that of secure lending on relatively modest margins. Notwithstanding that, during the years prior to 2008, young companies without significant tangible assets to offer as security did in practice, on reaching the stage of early revenue generation, have some prospect of access to term lending underwritten through the UK Government's Small Firms Loan Guarantee Scheme (SFLGS). At a rather more mature stage, once a record of consistent revenue generation could be demonstrated, access to an overdraft facility secured against debtors became a possibility. Access to bank lending through these mechanisms is now all but closed for smaller emerging companies which have not previously had any such arrangements in place, and the continuation of such arrangements is uncertain even for companies with respectable borrowing histories.

SFLGS was superseded in January 2009 by the Enterprise Finance Guarantee (EFG) scheme as a mechanism to enable bank lending to companies without the collateral to secure normal commercial lending. The level of lending underwrite available under EFG is in certain respects less favourable from the banks' point of view than that formerly offered by SFLGS. The guarantee covers 75% of the principal amount of each loan, subject to an overall cap of 13% (increasing to 20% in 2012/13) across a bank's EFG loan book in any year. EFG rules enable personal guarantees to be taken in parallel with the government guarantee, but not preferentially over the element of lending not secured by the government guarantee. The guidance issued by the Department of Business, Innovation and Skills (BIS) on personal guarantees is, however, perceived as somewhat ambivalent. Whether for these or other reasons, the uptake of the scheme has fallen well short of expectations. The total annual value of the loans drawn under the EFG scheme has not in any year of its existence exceeded 66% of the limit of the facility put in place by BIS. Total annual EFG-backed lending has fallen from £737 million in 2009–10 to £301 million (50% of the facility in place) in 2011–12. [8]

The term-lending and overdraft mechanisms which in the past were the primary access routes to working capital and liquidity for UK businesses are now seen within the banks as having been widely misused during the years leading up to 2008. In general, the retrospective view is that facilities were made available in situations in which the risks involved were such that debt funding was inappropriate, and which should properly have been funded by equity. In the much more conservative and highly regulated lending climate now prevailing, there is an understandable reluctance to make conventional lending facilities available to small companies. The preference tends to be to offer mechanisms such as invoice discounting or debt factoring, which are regarded as more secure. These mechanisms may be well suited to the needs of businesses selling regular volumes of tangible items, when clear title passes to the buyer at the point of sale. They tend, however, to be more problematic in some other situations – for example, businesses whose sales involve elements of intellectual property and services, or businesses whose revenues are irregular. Both of these are common characteristics of emerging technology companies.

1.4.2. *Other funding sources*

In response to the perceived shortage of loan funding available to Scottish companies, the Scottish Loan Fund (SLF) was launched through the Scottish Investment Bank in February 2011, with a commitment of £55m of public funding, shortly afterwards supplemented by an additional £40m from four commercial banks. The fund, which is under private sector management, offers mezzanine finance designed primarily for established companies at the mid and larger end of the SME size range. Two deals (one at the £1m level and the other of undisclosed size) had been announced by the end of 2011. There have been indications that a number of companies considering SLF financing arrangements have considered the terms proposed to be onerous.

The current climate has seen the emergence of new loan funding mechanisms. Funding Circle, an online peer-to-peer lending broker, claimed as of May 2012 to have arranged in excess of £33m of loan funding into over 700 companies since commencing operations in August 2010 [9]. The payday loans company Wonga recently announced a move into the business market, offering loans of up to £10,000 for periods of up to a year [10].

The UK government has sought to promote a debate on the need for the creation and stimulation of non-bank sources of loan funding for smaller companies. The Chancellor's Autumn Statement in November 2011 announced the creation of an industry working group to address this topic. This group, chaired by Tim Breedon, CEO of Legal & General, reported in March 2012 [11]. Its recommendations included the consideration of mechanisms to improve access by mid-sized companies and SMEs to bond markets, the adoption of measures to encourage faster payment by large companies to SME suppliers and exploration of the potential for further development of mezzanine funds, peer-to-peer lending platforms and online receivables exchanges.

1.5 The implications for growing companies

As a generalisation, the overall picture emerging appears to suggest that UK companies may be living two different realities. Larger, more established (and thus probably more risk averse) companies are holding substantial cash reserves and deferring growth and investment commitments in a climate of economic uncertainty. Younger emerging companies with growth potential (which are likely to be hungrier and more ambitious, having less to lose) are in many cases severely constrained by a lack of access to finance.

Conventional thinking on the provision of equity funding for the growth and development of emerging high-potential companies has tended to refer to an "escalator" or similar concept, ie. a progression from initial friends and family funding to informal investment and eventually, in appropriate situations to venture capital investment. Along with this has gone the concept of "funding gaps" in this escalator, the existence, scale and position of these gaps having been the subject of regular debate over many years.

Whatever the situation in the past, the reality is now somewhat different, at least at the upper end of the escalator. A significant misalignment has arisen between the agenda and priorities of the angel investment community and those of venture capital houses, to the point where it is difficult for an angel-funded company with the potential for longer-term growth to access the capital required to realise that potential. The most obvious source of further and larger scale investment would be venture capital, but this route is seriously problematic. It may be difficult to reconcile the valuation of the company at which angel investment was made with that which a VC investor would subsequently consider acceptable. Probably the most significant issue, however, is the almost universal requirement for liquidation preferences on the part of VC investors, which is seen as so disadvantageous to earlier investors that they generally prefer to see the company sold rather than continuing to grow as a free-standing business.

This is now giving rise to particular challenges for emerging companies whose medium to longer term development will foreseeably require levels of investment beyond the capacity of business angel syndicates. However promising the business proposition may appear, the fact that larger-scale follow-on investment would be required is a major disincentive to angels. VC investors, however, will not generally consider seed-stage investments. Certain of the sectors in which this issue is most likely to arise are particularly significant to Scotland – for example, life sciences and renewables. As the CEO of a startup Scottish life sciences company recently put it, "No-one in Scotland does what we need". There appears to be a need for a more sophisticated approach to the concept of funding gaps – rather than being "between £0.5 and 1.0 million" (or whatever), they are much more infrastructural and sectoral.

Scottish entrepreneurs and early-stage company managers sometimes draw comparisons between the scale of the resources available to them to grow their businesses and that of those available to their peers and competitors in the USA. It is not unusual to hear comments along the lines "They started out with ten times the total amount of investment we've ever had". Notwithstanding this, many young Scottish companies have proved themselves capable of significant achievements with the resources available to them, and have operated and competed meaningfully in US and other international markets. The ability to use resources efficiently and effectively is an invaluable attribute in business, and if our environment and mindset encourages this in young companies, that can only be a significant competitive advantage.

However, the early life of many high potential Scottish companies might reasonably be characterised as a hand-to-mouth existence. Relatively limited financial resources are made available on a staged or "drip feed" basis, each tranche dependent on the achievement of the next milestone. There is virtually no contingency to cater for the unforeseeable, and of course the unforeseeable invariably happens – and when it does the management team is inevitably thrown on to the back foot. Because one eye is always on the time-consuming and resource-intensive process of securing the next grant or equity funding injection, there is no point at which the company's entire management capability and energy can be devoted to building the business. Eventually, despite all this, the CEO and management team may succeed in driving the business forward to achieve a material market presence and reach a stable trading position. If at that point an opportunity to sell the company arises, tired and worn out as they probably are, they may see it as a welcome release.

This does not imply any criticism of any specific constituency; the players in this arena are all acting with competence and integrity in accordance with the rules applicable to them and in the perceived best interests of their stakeholders. There must, however, be a question as to whether, from an overall perspective, the outcomes are optimal.

To use an analogy, we have an environment that is well adapted to growing seedlings into pot plants for early sale; it is not well adapted to growing bushes, far less trees.

1.6. Discussion topics

1. Does Scotland's institutional investment community underestimate the scope for investment in high-potential growth companies located in Scotland? If so, why – and what could be done to change this view?
2. What steps could be taken in Scotland to stimulate greater interest from and manage more effectively the engagement of non-indigenous venture capital investors?
3. Business angel syndicates and venture capital funds are both in the business of seeking to grow shareholder value in high-potential companies. Are there any steps that could be taken to try to reduce misalignments of interest and build synergies?
4. What should be the future strategic role(s) of public funding in the seed and growth equity investment markets?
5. What is the appropriate role of debt funding in the growth and development of smaller companies? Are there any measures that could be adopted to help to achieve a balance between risk and return that would be acceptable to both borrowers and lenders in this context?
6. Without the talent, commitment and energy of the founders and managers of growing companies, there would be no role for investment or lending. Do we enable these fundamental assets to be mobilised and leveraged in the most effective manner?

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Part 2

REPORT ON PROCEEDINGS OF WORKSHOP EVENT HELD ON 31 MAY 2012

2.1 Discussion topic 1

Does Scotland's institutional investment community underestimate the scope for investment in high-potential growth companies located in Scotland? If so, why – and what could be done to change this view?

Scotland's institutional investment sector has been reported to have in excess of £750 billion of funds under management, and Scottish academic and other research organisations have a convincing record of generating world-class research with clear commercial potential. It has, however, been observed that there is almost no evidence of interaction, or even visibility, between these two communities.

There are issues of:

Scale: institutional investors will never wish to deal directly with individual investments on the scale relevant to emerging companies. Their lower limits of viability for individual placements tend to be in the range of tens or hundreds of millions. There will always be a need for some intermediary mechanism between institutional investors and individual emerging companies. This function is currently fulfilled primarily by the venture capital sector, in particular the specialist VC houses which genuinely invest risk capital in high-potential businesses (as distinct from activity more characterised as "financial engineering").

Risk: Fund managers may work within defined limits on levels of exposure to specific geographic regions or asset classes. Concerns have on occasion been expressed by institutional fund managers about the prospect of putting money into several Scottish VC funds which might then co-invest in the same companies, thus concentrating rather than spreading risk. Investments of the order of £1-2 million in emerging companies are regarded by institutions as high risk, and as constituting a market which is driven to a large extent by tax incentives.

Potential: Scotland's record of growing emerging companies from startup to a scale which would register significantly with institutional investors is not outstanding (particularly in the technology sector). It was suggested that, as a generalisation, technology companies emerging from the Cambridge environment tend to be driven by more substantial market opportunities than those emerging from the Scottish environment, with consequently larger potential returns on investment. The fundamental quality and commercial potential of the output of the Scottish research base is, however, considered comparable to that of Cambridge.

It was, however, noted that, notwithstanding these considerations, a significant number of institutional fund managers are active as individuals in the business angel community. This would seem to suggest that, whilst in their professional capacities they have either no inclination or no opportunities to direct funds towards the emerging company market in Scotland, their view is somewhat different when investing their own resources on their own account.

Reference was made to the role of the Scottish public sector pension funds. There has been little evidence of systematic consideration by these funds of the potential of their investment strategies to make an impact on the Scottish economy, although it was suggested that this may be beginning to change. For example, the Strathclyde Pension Fund is one of the investors in the Scottish Loan Fund, and has indicated its intention to invest in a specialist VC fund targeting the Scottish life sciences sector; the amounts involved are, however, relatively modest.

It was noted that even funds such as university endowments, whose origins and background might be expected to predispose them to invest in emerging technology companies, have demonstrated only a very limited appetite for doing so.

It was suggested that a fund of the order of £500 million might be commensurate with the scale of investment required to realise more fully the potential of the high-growth companies that could be created in Scotland. (The overall amount of equity investment by independent "third-party" investors in unquoted companies in Scotland is believed currently to be of the order of £100 million per year). It was noted that in the prevailing environment it would not be realistic to look to government as the primary source of capital for a fund of this size – other more imaginative approaches would be required.

Reference was made to the "prioritised return" model used by the UK Government's Enterprise Capital Fund (refer to notes on Topic 4). This approach might equally be workable with a fund involving institutional money.

The establishment of a dialogue with Scottish Financial Enterprise was seen as a key preliminary step towards more effective engagement with the institutional investment community in this overall context.

There could be benefit in trying to draw more on collective past experience. Systematic knowledge and understanding of the funding histories of successful (and less successful) innovative Scottish companies seems to be limited. There may be a case for research to generate better insights into strategies and approaches which have worked well, and those which have worked less well.

It was also suggested that, in view of the current very high levels of cash balances held by UK non-financial companies, there could be scope for some initiative(s) to incentivise investment by large corporates in emerging companies.

2.2. Discussion topic 2

What steps could be taken in Scotland to stimulate greater interest from and manage more effectively the engagement of non-indigenous venture capital investors?

There is a market in internationally mobile venture capital investment, and in this context there is a need both for Scotland to attract the attention of appropriate investors and to encourage and support appropriate Scottish companies in presenting themselves as investment opportunities to external investors.

It was noted that some evidence of engagement with non-indigenous investors does exist, and that Scottish Development International has been active in trying to promote this. SDI and the Scottish Investment Bank are currently embarking on an initiative to engage with VC investors based outside Scotland.

There is no fundamental reason why heavy, sustained external capital investment in Scotland should not be achievable. It has happened in contexts where the case for it has been perceived as compelling – an example being the oil & gas sector in the north-east (although the specific and unique characteristics of this sector are recognised).

Whilst the twin objectives of

i) raising Scotland's profile as a location of interest to external investors and

ii) greater exposure of specific compelling Scottish investment opportunities to investors outside Scotland

are distinct, there must inevitably be a correlation between them. The first is not possible without the second, and the second will automatically tend to achieve the first.

There is a case for considering the establishment somewhere in the Scottish infrastructure of a team specifically dedicated to addressing these related objectives.

It was suggested that the organisation of "investment trade missions" might be a means of building on what has already been achieved, and that the GlobalScot network might have a role to play in such an initiative. There may also be scope for a more structured approach to participation by Scottish companies in some of the investment conferences and similar events held in London and other European and US centres.

Consideration of non-indigenous sources of investment should go beyond the venture capital sector. It was noted that, at present, many of the family offices based in London have very substantial liquidity.

2.3 Discussion topic 3

Business angel syndicates and venture capital funds are both in the business of seeking to grow shareholder value in high-potential companies. Are there any steps that could be taken to try to reduce misalignments of interest and build synergies?

Scotland has a well developed business angel infrastructure, and it plays a highly effective role in funding the development of early-stage companies of certain types. There are of course limits to its overall investment capacity, and the current environment is imposing increased demands on that capacity to fund the working capital needs of existing portfolio companies.

All external equity investments in unquoted companies are made in the hope of achieving at some future point a liquidity event (exit) for the investors. The current environment has caused angel syndicates to focus increasingly on companies that can be grown to exit on the basis of a total amount of investment not exceeding the capacity of the syndicate, together with any co-investors involved. This tends to introduce a focus on seeking an exit at the earliest viable opportunity, and where this is possible it is almost inevitably by trade sale. In many cases (for example, single-product businesses which would be unlikely to be realistic candidates for flotation under any circumstances), this may be a positive and worthwhile outcome for the founders, investors and the overall economy. In certain cases, however, it may mean that opportunities to grow independent businesses to significant scale remain unrealised.

The pattern of investment and exit described above is not of itself unique to Scotland – it applies to angel-funded businesses globally. It does, however, arguably have a particular significance for an economy of Scotland's relatively small size, in that the majority of acquisitions are by non-indigenous entities. Such acquisitions may result in some proportion of the proceeds flowing into the Scottish economy – almost as an equivalent to export earnings – but they result in the loss of local control of the business and often of the economic impact of its post-acquisition growth.

There are significant differences between the agendas and motivation of business angel and VC investors, and thus between the priorities of the two constituencies. Angel investment is motivated to a significant extent by tax incentives available through the Enterprise Investment Scheme. EIS rules limit investors to holding ordinary shares. VCs will invariably require shares carrying liquidation preferences – generally regarded as likely to disadvantage early investors materially. This acts as a disincentive to angel-backed companies going on to seek venture capital investment as a route to the realisation of longer-term growth potential.

This is not, however, the only reason why a graduation from angel to VC funding may be problematic. Along with a substantial injection of VC funding will come very challenging new growth expectations and targets, changing the risk profile and characteristics of the business. There will inevitably be changes in structure and management. The existing management team may have run out of energy, and may also lack elements of experience relevant to the next phase of growth. Some or all of its members are likely to be displaced – possibly on an amicable basis, but possibly not. These changes are likely to remove almost entirely the influence previously held by early-stage investors, leaving them in a largely passive position – another disincentive to pursing this course.

For all the reasons outlined above, the concept of a smooth and seamless "funding escalator", enabling companies progressively to access increasing levels of investment as they grow, is not a reflection of the present reality. There should be a more sophisticated and realistic understanding on the part of emerging high-potential companies of the equity investment environment, and of the probable implications of early investment decisions. It is important that the objectives, priorities and funding capacity of investors should be aligned with the anticipated medium- to long-term trajectory of the business.

There are mechanisms which could be considered as ways of improving the overall efficiency of the equity funding environment. One of these might be the initial subscription of early investors' funds (at a stage when objective valuation of a company is virtually impossible) in the form of a loan convertible at a discount to the share price established at a subsequent equity funding round. At present this would render an investment ineligible for EIS relief. There was no clear consensus on the appropriateness or effectiveness of this approach.

Another mechanism believed to offer the potential to create a more progressive funding environment would be an effective market in secondary investment, enabling early investors to be bought out at least partially as subsequent larger-scale funding becomes appropriate. One effect of this would be to allow early investors to recover some degree of liquidity, thus increasing their capacity and possibly their appetite to invest in new opportunities. This could significantly alter the dynamics of the relationship between companies, their early investors and other subsequent investors.

It was noted that there are some 300,000 households in the UK in which the 50% tax rate is paid, whereas there are only around 10,000 individuals active in making EIS-qualifying investments. One possible inference is that there may be a sizeable community of people who would consider making investments in small unquoted companies, but not necessarily at the level or in the way in which business angels typically do so. If this is the case, mobilisation of this investment potential would require a more developed retail infrastructure.

The Venture Capital Trust (VCT) model was designed essentially with this purpose in mind. There is believed to be a view in certain government circles that VCTs have in some cases been badly mismanaged and the VCT mechanism widely abused. Notwithstanding this, recent changes to VCT rules were designed to increase their investment capacity. It was suggested that a "Caledonian VCT" could play a significant role in increasing the availability of equity investment. If a fund of this type could be structured in such a way as to allocate a proportion of its assets to the purchase of unquoted company shares from earlier investors, it could also go some way to addressing the secondary market objectives outlined above.

Consideration should be given to how well the existing investment environment in Scotland addresses the needs of companies of varying types, characteristics and sectoral backgrounds. For example, particular challenges appear to face startup companies which will foreseeably require higher levels of equity funding (ie. beyond the capacity of the business angel community) before they are likely to be in a position to achieve an exit for investors. This scenario is commonly characteristic of certain sectors, including the life sciences and renewable energy.

It was noted that the market in unquoted equity investment is much less developed in Europe than in the USA. Reference was made to a recent report indicating that the overall amount of VC investment in Europe is around 20% of that in the USA (*Globalising venture capital: global venture capital insights and trends report 2011; Ernst & Young*).

Reference was made to the suggestion sometimes put forward by some commentators that one possible route to realising more fully the potential of early-stage companies is by merging them to create more substantial and broadly based entities. This approach was not seen as productive – incompatibilities between expectations, stages of development and other factors mean that such mergers very seldom work.

2.4 Discussion topic 4

What should be the future strategic role(s) of public funding in the seed and growth equity investment markets?

The Scottish Investment Bank's equity funds are considered to have played a major and important role in stimulating investment in unquoted companies in Scotland. The model and approach adopted by SIB is broadly viewed as appropriate and constructive.

It was noted that the £113 million Scottish Loan Fund, designed to provide mezzanine funding, had in the first year of its existence announced only two deals amounting to a total of £6.5 million. A further announcement, likely to take the total value of SLF activity over the £10 million mark, is believed to be imminent. There have been indications that a number of companies considering SLF financing arrangements have considered the terms proposed to be unviable. The SLF must, however, operate within the parameters and conditions agreed with the parties which provided its funding.

Further consideration might possibly be given to the question of whether SIB could operate more strategically in seeking to increase the level of ambition on the part of emerging Scottish companies, and to create a funding environment more supportive of the realisation of longer-term growth potential. It was suggested that, whilst present constraints on public funding are well understood, any feasible ways of increasing the scale of SIB's activity would be worth exploring.

The UK Government's Enterprise Capital Fund (ECF) uses public funding alongside private capital to stimulate the creation of smaller niche venture capital funds, an element of the UK venture capital sector considered to be underdeveloped. The ECF funding model involves a 4.5% prioritised return on the public money placed in a fund. Uptake of the scheme has been encouraging; eleven funds incorporating ECF money having been launched. It is understood that ECF currently has the capacity to participate in up to three new funds per year.

Another aspect of the application of public funding in this context is the role of the public sector pension funds. Reference to this is made in the notes on Topic 1.

2.5 Discussion topic 5

What is the appropriate role of debt funding in the growth and development of smaller companies? Are there any measures that could be adopted to help to achieve a balance between risk and return that would be acceptable to both borrowers and lenders in this context?

The commercial banks and the corporate sector are living with the legacy of the lending criteria and practices of the pre-2008 period. The retrospective view within the banks tends to be that much of the corporate lending at that time (particularly to smaller businesses) was inappropriate, and that in many cases the companies involved should have been looking to equity rather than debt funding. One consequence of this has been that many businesses became over-leveraged, and are now operating largely to service debt.

It was suggested that, from an overall economic perspective, Scottish businesses have been too dependent on debt and too thinly capitalised (the ratio of corporate equity to debt is significantly higher in the USA). The total debt of Scottish non-financial businesses is around £34 billion, and servicing debt will be more expensive for the foreseeable future.

As far as the banks are concerned, their rules of engagement with businesses (particularly smaller businesses) have now changed very substantially, and this is not fully appreciated by the non-financial business community. The impacts of the regulatory environment on the banks' capital ratios, their evaluation of differing asset classes and their risk and default analysis processes have received little mainstream media attention and have not been articulated very effectively to the business community.

Smaller companies, however promising their potential, are now largely excluded from access to debt funding through conventional term loan or overdraft facilities, and regulatory pressures have played a role in bringing about this situation.

The impacts of regulatory measures at both the domestic and the European level are only likely to increase. For example, the indications are that the new Financial Conduct Authority will analyse the banks' capital reserves differentiated against specific asset classes, and will require adjustments on a dynamic basis to forestall the emergence of bubbles in specific asset classes.

The Enterprise Finance Guarantee scheme does not appear to be having as much impact as was anticipated. Confusion was caused by rule changes applied during its early stages, and the level of uptake has fallen significantly short of the provisions put in place.

In cases where banks might consider offering debt funding to more mature small companies, the perceived risk profile is such that pricing is high. A fundamental criterion for viable debt funding is that a company must be able to use it to generate a return which justifies the cost of borrowing. Current pricing of debt means that this criterion may be difficult to meet for many small and medium-sized businesses. In this context, the theory that lowering the central bank base rate would assist businesses by lowering costs of borrowing, thus providing an economic stimulus, shows little sign of being borne out in reality.

There is an acceptance within the banks that their own decision-making processes could usefully be informed by a more sophisticated understanding of the differences between the characteristics, operating environments and requirements of different types of businesses. There is a tendency to apply the same criteria and expectations to businesses across widely varying sectoral backgrounds. These criteria and expectations are more likely to be based on experience of conventional business models in long-established sectors (eg. construction, retail, etc.) than of those in emerging technology companies and other more innovative businesses. Banks in the UK could be encouraged to do more to understand and better address the needs of such businesses in the way that (for example) Silicon Valley Bank has done in the USA. Silicon Valley Bank has recently been granted a banking licence in the UK.

It was noted that even the more specialist lenders (such as Silicon Valley Bank), while they have substantial amounts of money available, still do not seem to find it particularly easy to identify lending opportunities.

A number of non-bank sources of debt funding are emerging and beginning to establish a market presence. Online peer-to-peer systems and short-term personal ("payday") lenders have begun to target corporate markets, and web-based invoice discounting services are now available. Volumes of activity are as yet relatively small, and only time will tell to what extent these mechanisms can play a more significant role.

From the viewpoint of smaller companies, another very significant aspect of the overall debt equation relates to the financial conduct of larger businesses to which they supply. It was suggested that in some cases the payment terms and practices imposed by large companies on their smaller suppliers amount to unfair trading. The cashflow impacts of this on small companies can be very serious, and legislators and regulators have shown little inclination to take serious steps to address such abuses of relative negotiating strength.

2.6. Discussion topic 6

Without the talent, commitment and energy of the founders and managers of growing companies there would be no role for investment or lending. Do we enable these fundamental assets to be mobilised and leveraged in the most effective manner?

The process of establishing and starting to grow a business will always be inherently challenging. Success will usually depend on a combination of attributes, including technical and commercial expertise and experience, enthusiasm and drive, intense determination, capacity for sustained hard work and an exceptional level of willingness to live with risk. Individuals who possess these attributes are relatively rare.

It is therefore reasonable to argue that public and other support infrastructures should not act to too great an extent as substitutes for the capabilities and motivation of startup entrepreneurs or teams. The startup and early stages should not be made too easy, because the longer term certainly will not be.

It is, however, at least as problematic if the environment – and specifically the extent to which and the channels through which resources are made available to startup and early stage companies – is exceedingly challenging, unresponsive or demanding. The energy and enthusiasm of an early-stage company may be exceptional, but it is not infinite. The more of it that has to be expended on finding and securing the non-revenue resources required to enable the establishment and development of the business, the less can be directed to market-facing activities which will actually grow the business. The Scottish environment seems at times to absorb an excessive amount of the energy of young companies in doing the former.

In a significant number of cases, the only functional or operational reason why companies (particularly innovative technology companies) are based in Scotland is the fact that their founders or founding teams are resident here. Market, financial and other operational considerations would logically locate them elsewhere. Family ties, quality of life and other factors may act as primary anchors, but it is critically important to offer a business environment that enables young companies to realise their potential from a Scottish base.

A substantial level of public funding has been directed into Scottish universities with a view to seeding the creation of new businesses based on academic research. Less support has, however, been available to stimulate the creation of innovative businesses which may have equally significant potential but do not have university roots or connections. Also, companies which do emerge from an academic environment can face major challenges in seeking the funding required at and beyond the point of spinout to begin to realise their potential in a commercial environment.

It is important to consider the operational as well as financial requirements of young companies. There are almost invariably gaps in skills and experience, some of which cannot realistically be addressed by conventional employee recruitment (either because finances do not permit or because only interim or limited part-time input is required). Informal networks can play an important role in helping companies to find viable solutions.

The primary focus of business schools has always tended to be on training and preparation for work in larger corporate environments, and this is the aspiration of the majority of their graduates. A small proportion might however be responsive to the idea of becoming involved in a startup situation, but there is no mechanism for identifying such people or helping them to establish relevant contacts.

As the group of Saltire Foundation Fellows grows, their experience could perhaps be publicised more widely in Scottish business schools with a view to stimulating greater interest on the part of new generations of students.

Part 2, Annex 1:
Specific suggestions by participants

At the conclusion of the workshop, participants were invited individually to suggest actions or initiatives that they would regard as important contributions to improving the financial environment for innovative businesses in Scotland. The suggestions put forward included the following:

- Promote the establishment of a "Caledonian VCT" as a means of broadening the base of investors in unquoted Scottish companies.
- Develop a more coherent approach to attracting equity investment from outside Scotland; find ways of preparing our best businesses thoroughly for exposure to an international investment audience and putting them in front of the right non-indigenous investors.
- Evaluate the potential for the creation of a fund similar to the Business Growth Fund to address the current gap in provision of loan funding; consider who would need to be involved and how pricing would be determined.
- Continue to support and as far as possible augment the capacity of the Scottish Investment Bank.
- Conduct an exercise to review the current infrastructure designed to provide financial and other support to growing companies; consider whether resources could be directed better to meeting the needs of our most successful companies.
- Consider what steps could be taken to mobilise more of the capacity of Scottish public sector pension funds to support the growth of indigenous businesses in ways which would benefit both the funds and the Scottish economy.
- Undertake work to investigate the views of businesses on equity investment as a source of funding (only 3-5% of businesses have external equity investment).
- Consider initiatives to improve the level of mutual understanding between commercial bankers and smaller companies (particularly technology-based and other innovative companies).
- Consider measures which would enable more recycling of early-stage investment funds.
- Promote the establishment of retail channels for both debt and equity investment.
- Establish a recurring event which would bring entrepreneurs from across Europe, the USA and beyond to Scotland to meet and interact. A broad approach similar to the annual Mobile World Congress in Barcelona was suggested – do for entrepreneurs globally what MWC does for the mobile telecoms industry.
- Consider the use of corporation tax relief to influence the behaviour of venture capital funds.
- Enforce fair terms of trade (specifically as regards payment terms to smaller suppliers) on larger companies.

Part 2, Annex 2: Workshop participants

Brian Butchart
Chief Executive, Sirakoss Ltd.

Mary Campbell
Chief Executive, Blas Ltd.

Stephen Campbell
Partner, Panoramic Growth Equity

William Duncan
Chief Executive, Royal Society of Edinburgh

Gordon Eadie
RSE Business Innovation Forum

Sandy Finlayson
Senior Partner, MBM Commercial LLP

David Grahame
Executive Director, LINC Scotland

William Hardie
Policy Officer, Royal Society of Edinburgh

Jonathan Harris
Editor, Young Company Finance

Gerard Kelly
Formerly Head, Scottish Investment Bank

Colin Mason
Professor of Entrepreneurship, Hunter Centre, University of Strathclyde

Donald MacRae
RSE Business Innovation Forum

Ian McCall
Head, Investment & Entrepreneurship Policy Team, Scottish Government

John McCormack
Chief Financial Officer, Fruit Mobile Ltd.

Neil McInnes
Director, Corporate Finance, Grant Thornton UK LLP

Ian Mitchelmore
Relationship Director, Wholesale Banking & Markets, Lloyds Bank

Andrew Moorhouse
Director, Commercial Banking - Edinburgh, Royal Bank of Scotland

Ian Ritchie
RSE Business Innovation Forum (Chair)

Graeme Sands
Head of Growth Finance, Clydesdale Bank

Adrian Smith
Chief Financial Officer, Ecometrica Ltd

John Waddell
Chief Executive, Archangel Informal Investment Ltd.

Part 3

PRINCIPAL RECOMMENDATIONS

Having reviewed the outcomes of the consultation, research and discussion which have taken place and which are documented in this report, the RSE Business Innovation Forum wishes to put forward the following principal recommendations:

1 That a senior level advisory group should be established to investigate and report on the feasibility of mobilising new sources of risk capital in Scotland. The remit of the group should include:

> Consideration of the factors influencing the extent of interaction between Scotland's institutional investment community and its non-financial corporate base, and formulation of practical proposals as to how that interaction might be developed to the benefit of both constituencies. Factors for consideration would be likely to involve, inter alia:

- the attitudes of institutions such as pension funds (and in particular Scottish public sector pension funds) to allocation of funds.
- the parameters and constraints within which investment fund managers are required to operate.
- attitudes to and perceptions of risk, particularly in the context of emerging technology companies and other significantly innovative businesses.
- the factors (non-financial as well as financial) which bear on the capacity of emerging Scottish companies to achieve their full potential, and thus to be perceived as compelling investment opportunities.

> Investigation of the feasibility of creating an investment fund (possibly using a Venture Capital Trust structure) with the following principal objectives:

- investing in emerging Scottish technology companies and other significantly innovative businesses, typically at a stage where they have achieved a worthwhile market presence and can demonstrate the potential for very significant further growth.
- providing a source of growth capital beyond the levels generally available through business angel syndicates.
- offering an element of replacement capital, buying out at least a proportion of the holdings of early investors to facilitate the recycling of seed investment from business angel and similar sources.
- creating a retail channel capable of mobilising personal investment into unquoted companies, accepting subscriptions from individual investors at levels below those typically committed by business angels and spreading risk for individual investors at any level.

2 That the infrastructure available to support Scottish companies in connecting with sources of equity investment outside Scotland should be reviewed. This would involve consultation with a range of interested parties across both private and public sectors, with a view to investigating:

- whether and how a more coherent approach might usefully be taken to facilitating interaction between Scottish companies and equity investors internationally.
- how emerging Scottish companies of the highest potential can most effectively be prepared for and presented to an international investment audience.

3 That an evaluation should be undertaken of the potential for and feasibility of creating (a) new vehicle(s) to provide access to loan funding for emerging Scottish companies on terms which would be viable for the businesses and acceptable to the lenders. This would involve consideration of a range of issues including:

- formulation of a different view of risk and pricing from that which the commercial banks are now required to take.
- the structure and management which would enable any such vehicle to operate.
- the potential sources of the funding required, and the role which public funding might play.

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THE ROYAL SOCIETY OF EDINBURGH

The Royal Society of Edinburgh
22 – 26 George Street
Edinburgh
EH2 2PQ

T **0131 240 5000**
F **0131 240 5024**
E **info@royalsoced.org.uk**
W **www.royalsoced.org.uk**