

The First Venture Capitalist: Financing Development in Britain After 1945, The Case of ICFC/3i

Richard Coopey
London School of Economics

Banks and Industry in Britain

The funding of industry by banks and the capital market is closely interlinked with the debate on the relative decline of the British economy. Briefly, this debate centers around the notion that the finance system has somehow failed British industry and within this system, the role of banks has been an important factor [3; 14]. Mirroring the general debate, the "failure" of British finance is seen to be either cultural, structural or functional, although there is considerable overlap within these explanations. Cultural explanations point to the gap between the social and educational background of bank directors and staff, and those involved in industry--and forms part of the cultural debate initiated by Martin Weiner [4; 20].

Structural explanations, point to the fracture, into the 20th century, between bankers and entrepreneurs--once embodied in the same person as a Schumpeterian banker-entrepreneur, or closely tied through the local financial-industrial community [5; 8]. This trend is precipitated by the growing concentration and specialization of banks into national, centralized and bureaucratic institutions [5; 18] Functional explanations point to the chosen paths which banks follow in ensuring returns on investments. The general accusation is that banks in Britain, in common with finance capital in general, have chosen at key moments to invest in non-industrial areas, typically overseas, or have been over anxious to ensure liquidity or high levels of security which militate against industrial, long-term capital investment.¹

The reason for this failure on the part of banks to invest in industry can be seen to stem from historically specific reasons peculiar to Britain. The creation, early in the twentieth century of a small oligopolistic cartel, content with low, relatively risk-free profits [11]; the problems ensuing when these banks

¹It must be noted that the definition "banks" used here is a problematic one. The major clearing or retail banks in Britain, principally Barclays, Natwest, Midland and Lloyds do not traditionally have the "universal" functions of, for example German banks, which have a history of closer involvement with industry through investment. Although the Merchant Banking sector in Britain does have such an involvement it does not operate as a general deposit taker.

did become forced to turn their long-term overdrafts into loans during the depression; a general *laissez-faire* ideology among bank managers and chairmen eschewing industrial involvement; and a faith among banks that the capital markets could adequately supply industry's needs. Historically then, the picture is one of a banking system in Britain which has developed a long tradition of non-involvement with industrial, and technological investment and hence has not generated the kind of investment "culture" and practice which is required to invest in these sectors. This is compounded by the reluctance of banks to invest in smaller sized companies, often the generators of innovations and always in need of start-up or development capital.

This paper will consider the development of an alternative institution to the above stereotype, which, although linked to the major banks, developed a different investment strategy based on long-term industrial investment, a high proportion of which was in the small and medium sized firm sector. Industrial and Commercial Finance Corporation (ICFC), was founded in 1945 and later became the basis of 3i, currently Britain's largest development capital institution. Of particular interest, from the 1960s onwards, is a specific subsidiary function of ICFC, designed to invest in technology projects. Technical Development Capital (TDC) was set up in the 1960s, later to become 3i Ventures. The experience of this enterprise in investing in high technology reveals the relative success of an alternative investment model, but also the ways in which institutional forms and culture can constrain them. In addition to contrasting ICFC and TDC and their derivatives to the traditional banking sector in Britain, this paper will also consider their relationship to another development in the finance of industry in Britain--the growth of venture capital.

ICFC: The Earliest Venture Capitalist

Venture capital² is often held to have filled a gap in the financial system in Britain. An early recognition of such a gap was tentatively put forward by the Macmillan committee in the early 1930s, which published its report during the depression in 1931. This highlighted a perceived structural failure within the financial system which meant that unquoted small and medium sized firms requiring long-term investment capital were unable to afford an approach to the capital market and were poorly catered for by the banks. This hypothesis became popularly known as the "Macmillan Gap" [1; 12]. During the closing years of the war, plans were made by the government to manage the transition to a peacetime economy, many of which were predicated on the notion of a probable return to depression. Solutions to economic problems which had emerged during the 1930s, most notably Keynesian economics were to achieve prominence in 1945.

²Venture capital is a general term used to describe a form of investor, institutional or otherwise, characterized by long-term, equity-based investment, frequently involving start-up, growth or management buy-out capital often in advanced technology fields such as information technology or, more recently bio-technology. This type of finance is popularly held to have begun in the USA in the early 1950s and spread to Britain in the 1980s. Venture capitalists are held to be "hands-on" investors, actively intervening in company management, and seek a capital gain rather than income stream.

Likewise the observations and recommendations of the Macmillan Committee, were also re-examined. Between 1943 and 1945 a series of plans and proposals were debated by Government departments (notably the Treasury and the Board of Trade), the Bank of England, the Clearing Banks and the Labor Party which eventually led to a decision in 1945 to establish two new institutions. Finance Corporation for Industry (FCI) was set up to provide finance for large scale long-term investments, aimed at industry wide rationalization. ICFC was set up to cater for small and medium sized enterprises.

The precise origins of FCI and ICFC can be found within Whitehall with the setting up of the Committee on Post-War Employment in July 1943. Treasury representatives on this committee successfully resisted the efforts of those on the Board of Trade to establish a new institution, funded by government and linked directly to a policy favoring chosen sectors of industry. The Treasury, which was operating in close consultation with the Bank of England preferred an alternative strategy based upon private sector funding. Despite this it was hoped that the new institution would invest in designated areas, informally following the policies pursued by the Special Areas Reconstruction Association (SARA). This organization was set up in 1935, capitalised by the City, insurance companies and industrial companies in equal proportion. Again this was seen by the Bank of England as a preemptive move to offset greater government interference [12].

The major force behind the establishment of the new institutions remained the Bank of England. Having set up its own Committee on Post-War Domestic Finance in March 1943, the Bank's policy soon emerged as one determined to resist the encroachment of government departments in the financial system, even in the limited form envisaged by the Treasury [6; 10, pp. 705-08]. To this end the Bank proposed that the five major clearing banks should fund a new institution designed to meet criticism that they had neglected long-term investment in British industry. Talks with the clearers took place throughout 1944, and it is evident that a majority of the latter's representatives resisted any such initiative. In the event the Bank of England successfully convinced the clearers that they should be seen to be taking the initiative, given the adverse publicity they had experienced, the threat of nationalization which was still being mooted in some quarters, and the fact that the war had left them with a high level of liquidity.

The result of these competing pressures trying to shape or frustrate new initiatives, was that when ICFC was established in 1945, although it had a tacit mission to invest in predetermined ways, it remained free from formal direction or control by either government, the Bank of England or the clearing banks, the latter two being the corporations' shareholders. The hostility which had been expressed by some of the clearers to the foundation of ICFC which they saw as a move towards "continental" banking, politically directed, was provoked further by the appointment of the Corporation's first chairman, Lord Piercy. Piercy, and James Lawrie--ICFC's first General Manager--were both prominent members of XYZ, a group of Labor sympathizers in the City advising Hugh Dalton³ on policy [9]. During the 1930s, the Labor Party had considered, and rejected, direct

³Labor Government Chancellor of the Exchequer from 1945 to 1947.

intervention in the financial system, through some form of National Investment Board, but had eventually rejected this in favor of more general controls of the monetary system and nationalization of key sectors of industry [19] Nevertheless Piercy was seen as representing a distinct political control of ICFC and this served to further alienate the clearing banks.

ICFC was thus set up with a distinct "national" mission--to invest long-term funds in the MacMillan gap, with identified limits between £5000 and £200,000. Yet the Corporation was formally an independent entity, not controlled by Government or the central bank in terms of the precise direction in which it chose to invest. Its own shareholders had been forced to support it and were thus reluctant to provide operational support. It had been envisaged that the banks would pass on long-term investment business to ICFC when such investment fell outside the former's normal remit. This proved to be a forlorn hope however as, during the early years, some of the banks limited the number of introductions sent to ICFC, often sending hopeless cases, and frequently did their best to undercut the efforts of the Corporation by offering loans themselves once they learnt of an approach to ICFC [6; 15].

ICFC was forced to develop its own methods of attracting and evaluating business, and needed to ensure commercial returns to ensure its own survival, since it could not hope to be bailed out. Indeed the shareholders tried on several occasions to limit the Corporation's activities by restricting its supply of either share or loan capital, or pricing loans to the Corporation at high rates. On each of these occasions ICFC was forced to rely on the patronage of the Bank of England which acted as the corporation's guardian, insisting that the clearers honor their original commitment. The support of the central bank did not extend to enhanced financial provisions however and in order to secure the long term future of ICFC the corporation had to demonstrate its ability to make a profit.

Limited to the SME sector of the market, the type of investments which ICFC was called upon to make were typically in firms with no real historical accounts, lacking security, and requiring long-term investment, preferably with low debt repayment burdens. In order to counteract these difficulties ICFC evolved a system of risk reduction based upon technical and market assessment of proposals, building up its own "industrial department", rather than rely on consultancy advice as was the common practice among banks. Stress was also placed on the quality of management within proposed investee firms. Thus a typical proposal placed before ICFC's Cases Committee--a decision making forum to which a presentation had to be made--would comprise an equal element of accounting, technical and managerial assessments. It is important to note that once an investment had been made by ICFC no direct control was undertaken. The Corporation retained a policy of not placing staff on the boards of investee companies and, where equity involvement was undertaken, of not exerting pressure to realize investments.

Another crucial difference between ICFC and the banks was the latter's attempts, wherever possible to take an equity stake in the firms which it invested in. Many firms resisted this, but a sufficient number were prepared to give a share of the firm to ICFC, and this had a dual effect. First, it reduced the firms debt burden, and second, and most important, it meant that when firms were

successful ICFC shared in that success pro-rata. Unusually large investment returns could cover losses made by other failures in the portfolio.⁴

Operating in this way ICFC grew steadily throughout the 1950s. A branch network of offices was established to market the Corporation more effectively and to glean local knowledge of markets, creditworthiness, etc.. Subsidiary activities were also developed during the 1960s. The Estate Duties Investment Trust (popularly known as EDITH) was set up to provide an institutional investor to replace the loss of a major shareholder in unquoted companies. Ship Mortgage Finance was established to provide finance for the construction and chartering of shipping. Of particular interest, however, is the involvement of ICFC in Technical Develop Capital, from 1962 onwards. Given that two key definitional characteristics normally ascribed to venture capital--hands-on management of investments and a concentration in technology-based activities--seem to apply to aspects of TDC's activity it may be worth examining this subsidiary in some detail.⁵

ICFC as Venture Capitalist

In terms of technology-based investment the ICFC-TDC link reflected the Corporation's somewhat recondite political origins. From the early 1960s fears of a widening "technology gap" had been expressed from many quarters, often pointing to the failure of British industry to capitalise on indigenous research. Technology had been given a very high profile by the Labor Party in the run up to the 1964 General Election, when Harold Wilson had made his famous speech calling for a revitalized manufacturing sector "forged in the white heat of the scientific revolution" [7]. Following Labor election victory in 1964, increased government activity through existing bodies like the National Research Development Corporation (NRDC) and the new Ministry of Technology, encouraged ICFC to become involved in this sector, as did the obvious and growing importance of high technology industries such as computers, electronics and aerospace.

TDC had been formed in 1962, partly in response to recommendations in the Radcliffe Report into the British monetary system, which had outlined the need for selective investment to finance the development and production stage of new technologies [17]. The company, which was the brainchild of Sir John Benn, Chairman of a British insurance company, UK Provident, started with a capital of £2 million, subscribed by the Provident and other insurance companies and other institutions. ICFC had been involved from the beginning, taking a 5% stake in TDC and providing the company with office accommodation. John Kinross, general manager of ICFC, was drafted in as a director, to sit on TDC's

⁴There were some very large equity returns. For example an investment just over £4.5m in British Caledonian Airways realized over £100 million when sold in 1981.

⁵There are other important links between ICFC/3i and the venture capital industry, notably the development of the Management Buy-Out and Management Buy-In Market, and the Corporations central role in developing the labor market in venture capital in the UK. For reasons of space these cannot be adequately dealt with here.

"Cases Committee" (a system adopted by ICFC to collectively assess prospective investments), with Edward Hawthorne, an engineer and full-time director, under the Chairmanship of Benn. The company, hailed as an "inventors charter" attracted a good deal of attention, not least among individuals wishing to find capital to back their private projects.

Early progress was slow in identifying winning technologies and three months passed before any investments were made. [15, pp. 194-96] Serious disagreements arose over the degree of risk to be taken in new investments. Benn advocated a more adventurous approach leading Kinross to regard him as somewhat of an "idealist," prepared to back projects from an almost altruistic point of view. TDC's performance continued to be unimpressive and in June 1966 it was decided that ICFC should make an offer for the whole company. This was accepted by the shareholders, who were happy to cut their losses, and the TDC was given a new lease of life under the full guidance of ICFC.

Lord Sherfield, who had replaced Piercy as chairman of ICFC and had previously been chairman of the United Kingdom Atomic Energy Authority, remained convinced that the SME sector would accelerate its investment in more sophisticated production technologies which were becoming available in the mid-1960s. During the 1960s many looked to the USA to provide an exemplar of successful high technology based commercial exploitation, and the venture capital industry was seen to have originated there. TDC board members were duly dispatched to the Massachusetts Institute of Technology to study "the most celebrated example" of institutional promotion of advanced technology "spin-off" [13, 1965].

In the first year of ICFC's ownership TDC increased its activities significantly, including two large investments in advanced machine tool projects. The following year, seeking to emulate MIT's methods, representatives from TDC held discussions with most of the universities in Britain, resulting in a programme of funding to enable the development of selected prototypes at Cambridge, and a jointly commissioned survey, with the NRDC, at Imperial College, to evaluate potential commercial development projects [7].

The level of TDC's investment activity continued to grow at a steady, if relatively modest level throughout the rest of the 1960s, and the number of failures was less than expected. Returns were not spectacular but it was recognized that "most of TDC's customers have still a long haul ahead of them." By 1970 the company had invested over £6 million in a total of more than 100 companies, but it was still held to be prudent to make substantial provisions against losses. However, investment levels began to fall significantly during the early 1970s, reflecting both problems with the economy in general, and the end of the romance with technology in Britain generally, and a lack of political pressure to be seen to be doing something about "technology gaps." TDC's overall performance was not totally unsatisfactory, and many of its investments eventually performed quite well. Firms such as Oxford Instruments, eventually emerged as leading firms in the 1980s. Nevertheless, from the perspective of the 1970s, TDC was seen as only a moderate performer, with no real "shooting stars" in its portfolio.

The TDC experience, in common with the many government technology initiatives of the 1960s, had demonstrated the problems inherent in investing in

what was, by its nature, a very volatile sector of industrial activity. Advanced technology projects were costly and carried a very high level of risk, calling for specialized knowledge of processes and markets and for a long term commitment on the part of the investor. TDC as part of ICFC, with its industrial department and its tradition of long-termism, was better placed than most financial institutions to evaluate potential investments, yet in this very particular sphere, they too had to admit more risk than they were accustomed to, as signalled by the debate between Kinross and Benn over the level of "altruism" appropriate in investment. The industrial experts within ICFC remained generalists, able to recognize production and marketing possibilities, but not necessarily attuned to the complexity of the R&D processes they were called upon to assess. In addition ICFC's tradition of "hands off" investment meant that they had little input beyond the initial investment decision, only being called in again when difficulties were encountered, often when companies were in terminal trouble. Even in the USA where a stronger venture capital industry had emerged during the 1950s, the "long haul" was the norm, and very few envisaged the spectacular returns which were to be experienced in the 1970s and 1980s [2, pp. 10-21].

ICFC's second foray into high technology investment was to come in the 1980s. In 1973 ICFC had combined with its sister organization, FCI, to form a group under the name of Finance for Industry (FFI). In the early 1980s, in a bid to rationalize the activities of this group and to push for a more effective marketing strategy the FFI group was restructured into a divisional organization under the new name Investors in Industry, later shortened to 3i. Within this new group TDC was revitalized and renamed 3i Ventures. The decision to re-emphasize investment in high technology at this time reflected the fundamental change in the finance sector in Britain during the 1980s--the rise of the venture capital industry.

In this atmosphere 3i Ventures was set to greatly expand 3i investment in high technology, notably in start-ups and high growth companies in microelectronics, computers, telecommunications, biosciences, and industrial automation, using its own funds and syndicated capital. In doing so the division was to adopt a "venture capital" modus operandi, varying in significant ways from the now traditional methods of the parent group. 3i ventures was to be run by staff with engineering and scientific expertise. Investments were to be run in a "hands on" way, with direct participation by 3i staff on the boards of investee companies. Another significant difference was the decision to allow staff in 3i Ventures to have a carried interest in any investments which the division made. This linking of personal remuneration to the performance of investments, typical in other venture capital companies, went against the traditional practice of the group and was, from the outset, a cause of considerable friction. 3i ventures was also to have a wider, international remit, setting up offices in the U.S. in California and Massachusetts--identified as regional centers of high technology industry. It was also hoped that high technology investments in the USA, with direct involvement by 3i, would result in technology transfers back to the UK [7].

3i ventures was initially quite successful. Two early investments in computer related technologies brought considerable gains at an early stage, and as the 3i group was restructuring in the mid-1980s, and looking for a new

corporate identity and new markets, it seemed possible that this new focus might come to dominate the activity of the whole group. However, the initial large gains were not replicated in the short-term, and, as with TDC before it, the new group had to be prepared a for lengthy interval before investments would show adequate returns. In addition, it proved more difficult than envisaged to identify worthwhile investments in the USA where the venture capital industry was considerably larger and more competitive.

Given the lack of tangible success, those elements within the 3i group which had been alienated by what they saw as the cavalier style of 3i Ventures became more vociferous in their criticism of the division. This criticism carried increasing force given a growing disillusionment within the British finance community generally, about the effectiveness of venture capital, which was now seen to be falling well short of its promised performance. In this atmosphere 3i Ventures began to come under increasing pressure and when, towards the end of the 1980s, 3i moved to rationalize its group activity and adopted a policy of returning to its "core" business and expansion into Europe, 3i Ventures was effectively closed down. No new investments were to be made and existing investments were transferred to a jointly owned management company [7].

Conclusions

The example of ICFC and its derivative 3i in many ways stands in contradistinction to the stereotype of banks and industrial investment in post-war Britain. By adopting an investment strategy centered on SMEs, and engaging in long-term, often equity-based investment, and by using in-house industrial expertise in assessment, ICFC/3i was able to operate successfully in a field deemed too troublesome and too risky by the major clearing banks. It did so despite the active hostility of some of the clearing banks, even though it was initially forced to rely on these institutions for capital.⁶

If ICFC stands apart from the activities of the banking sector in these respects does it more closely resemble the venture capital sector, with which it is frequently associated? Similarities seem to be apparent in terms of equity investment and risk, but there are important differences. The source of capital--initially provided under duress by the clearing banks, and later from the capital markets and the group's retained earnings--marks it off from many venture capital funds which are constrained to show their own investors (or parent in the case of subsidiary venture capital institutions), a return in the short-term [16]. ICFC's investigative machinery, and national network also stands in contrast to other venture capitalists.

The venture capital sector is often defined in terms of a readiness to invest in technology-based or start up firms. In practice venture capital in Britain during the 1980s has tended to be directed towards less risky investments, notably management buy-out or buy-ins. ICFC/3i has itself been through two phases of high-technology investment, both of which have distinct origins and

⁶The banks ceased to be ICFC's sole source of capital in 1959 when the Corporation was allowed to raise money on the capital market.

differing characteristics, and the limited impact of which illuminates a different set of impediments which arise when institutions consider investing in this sector.

The TDC initiatives of the 1960s suffered in that they had their origins, at least indirectly, in political pressure, a reflection of the general political influence in the establishment of ICFC itself, which was tangibly resisted by ICFC staff. Even with the risk reduction strategy of ICFC, using its industrial expertise in assessment, the corporation was reluctant to be forced to invest in a wide range of new technologies which would inevitably involve long lead-times and would not show returns on investment for many years. More importantly, ICFC's methods of monitoring investments, which did not involve direct participation or "hands on" involvement, meant that its industrial expertise was not available when it was perhaps most necessary--during later development, production and marketing stages of new technologies. Many of the nascent firms seeking capital from the group had their greatest difficulties in this area, being technologists first and commercially minded managers last [7].

The case of the 3i Ventures in the 1980s demonstrates a different set of impediments. In this case there were no overtly political origins to be resisted, and the methods used involved direct participation by 3i staff, themselves technology rather than financial experts. 3i Ventures used the same long-term equity-based investment methods which had proved successful since ICFC's inception. The division was unsuccessful however because of the animosity it aroused within the 3i group, precisely because of the closer links which were established between 3i Ventures staff and the client companies, in particular the practice of carried interest, which was common in the venture capital industry generally, but resisted in the mainstream of British banking. 3i Ventures was an initiative encouraged by the seeming success of the venture capital industry in Britain in the 1980s. When the expectancies of that industry proved to be seemingly oversold in the later 1980s, 3i Ventures became vulnerable, and its operations easily curtailed.

This perhaps reflects the life cycle of an institution like 3i, which, during its early life in the 1950s, stood in contrast to the major British banks--its own shareholders--in its more adventurous methods of investment. Given this contrast ICFC could be viewed as an early form of venture capitalist, at least in terms of its style of assessment and structure of investment. By the 1980s, certainly in contrast to the new venture capital movement, 3i had perhaps developed a more conservative culture, ready to reassert itself in resistance to the more radical methods and practices of 3i Ventures.

References

1. Bolton Report, Report of the Committee of Inquiry on Small Firms (HMSO Cmnd. 4811, 1970).
2. William D. Bygrave and Jeffrey A. Timmons, *Venture Capital at the Crossroads* (Cambridge, MA, 1992).
3. Forest Capie and Michael Collins, *Have the Banks Failed British Industry?* (Institute of Economic Affairs, 1992).
4. Bruce Collins and Keith Robbins, *British Culture and Economic Decline* (Weidenfeld and Nicolson, 1990).
5. Michael Collins, *Banks and Industrial Finance in Britain, 1800-1939* (New York, 1991).

6. Richard Coopey and Donald Clarke, *31: 50 Years of Investing in Industry* (Oxford, forthcoming 1995).
7. Richard Coopey, Steve Fielding and Nick Tiratsoo, *The Wilson Governments* (Pinter, 1992)
8. Philip Cottrell, *Industrial Finance 1830-1914: The Finance and Organization of English Manufacturing Industry* (Methuen, 1980).
9. Elizabeth Durbin, *New Jerusalems: The Labor Party and Economics of Democratic Socialism*, (RKP, 1985).
10. John Fforde, *The Bank of England and Public Policy, 1941-58* (Cambridge, 1993).
11. Leslie Hannah, "Effects of Banking Cartels," Paper for publication in New York University Salomon Centre, Proceedings of Conference on Anglo-American Finance edited by M. Bordo and R. Sylla (Richard Irwin, forthcoming).
12. Carol E. Heim, "Limits to Intervention: The Bank of England and Industrial Diversification in the Depressed Areas," *Economic History Journal*, 2nd series, Vol. 37, No. 4, (November 1984).
13. Industrial and Commercial Finance Corporation, Annual Reports, 1965-8.
14. Geoffrey Ingham, *Capitalism Divided? The City and Industry in British Social Development* (New York, 1984).
15. John B. Kinross, *50 Years in the City, Financing Small Business* (John Murray, 1982).
16. Gordon Murray, *Change and Maturity in the UK Venture Capital Industry* (Warwick, 1991).
17. Radcliffe Committee, "Report of the Committee on the Working of the Monetary System" (HMSO CMND 827).
18. W. A. Thomas, *The Finance of British Industry 1918-76* (Methuen, 1978).
19. Jim Tomlinson, "Attlee's Inheritance and the Financial System: Whatever Happened to the National Investment Board?," *Financial History Review*, No. 2 (1994).
20. Martin Weiner, *English Culture and the Decline of the Industrial Spirit, 1850-1980* (Cambridge, 1981).