Sarah-Jane Larkin: 'An innovation-driven recovery is possible'

As recession bites, could an innovation-driven recovery be possible for Ireland? Sarah-Jane Larkin, director-general of the Irish Venture Capital Association, believes so.

On first glance it looks rosy. During the peak of the Covid-19 outbreak, venture capital funding into Irish tech firms recorded its highest quarter on record reaching €363.8m for the period April-June 2020, up 58pc on the same period last year, according to the Irish Venture Capital Association (IVCA) VenturePulse survey published today in association with William Fry.

But, mirroring earlier figures revealed by TechIreland in recent weeks, there is a serious anomaly. First time funding during the second quarter fell by almost 60pc with only a handful of start-ups raising their first equity rounds.

There are a few stark reasons for this: investors doubled down on existing investments while caution sent angel investors diving for cover. A still ineffectual capital gains tax (CGT) regime also drove seasoned investors in the direction of lower-risk investments.

The bottom line, said IVCA director-general Sarah-Jane Larkin, we need to encourage more private investment in higher risk, high tech start-ups by increasing tax relief in these companies to a much higher level than the current 40pc.

Asked about the present situation and why funding in early-stage firms practically fell off a cliff Larkin explained: "The nature of the Covid impact between April-June – almost total lockdown – meant a complete halt in the type of face-to-face meeting with start-ups that venture capitalists (VCs) have relied on for years to make judgement calls – on the founders and the team and whether they are a sound bet slowed new investment activity.

"Secondly the lessons of the last crisis meant that VCs focused their attention very quickly on existing investments, both protecting and working out how much they would need to ride out the next 24 months with the investors already around the table, avoiding the need for fundraising as long as possible. Lastly private investors and angels tend to become very cautious in a downturn, and they step back from investment. In most seed deals they are co-investors along with VCs and others, so this caution meant a much slower decision-making process."

Investors hold onto their cash

Asked if it is only a matter of time before the real picture is no longer blurred by record investments by existing investors, Larkin replied: “I see it a little differently. Venture capital itself is cyclical – we are very lucky in 2020 that most Irish VCs had recently closed funds and had significant dry powder.

“The record numbers have front-loaded investment that otherwise would have been made over the next 24 months. Fund top ups to replenish funds are being looked at by both the EIF and Irish agencies. I genuinely believe given the numbers that an innovation-driven recovery is possible, and one that will rebalance the economy away from its reliance on FDI.”

Research earlier this year by Scale Ireland indicated that many start-ups in Ireland feared running out of cash the longer the Covid-19 pandemic crisis went on, with many existing on a few months of runway.

Larkin said that the IVCA lobbied alongside the Irish Government and other national associations along with Invest Europe to get the European Commission to extend the scope of the State Aid Temporary Framework to include start-ups, micro enterprises and small companies.

“While some of the new measures are slowly making their way to companies, the outlook for start-ups as a consequence and the support they can access is stronger.”

Either way, with most businesses working remotely and meetings taking place via video conference, could it be still difficult for early-stage companies to raise funding without the ability to physically meet potential investors.

“Difficult to say definitively – quarter 3 will answer this. VCs have adapted quickly – all are open for business, but I think some deals that might otherwise have gotten over the line might struggle without personal contact.”

All eyes will be on what Budget 21 will look like for an Ireland that has officially entered recession and a hard-pressed SME sector. For many years, groups like IVCA have been lobbying the Government to finally overhaul Capital Gains Tax (CGT) regime to enable company founders to yield more from M&A deals and continue to invest in the ecosystem. Will this change?

“We have the same frustration, so much so that we spoke to other members of the ecosystem – Scale Ireland, Technology Ireland and HBAN and agreed to align on a set of specific asks that we can all agree will make a difference. Rather than each of us asking for slight variations of the same measure – on tax incentive schemes we will try to make it easy for the Government to make some key changes that will move the dial. Even if only as a temporary measure during Covid.

“We were delighted that the current Government included for the first time a commitment to VC in the Programme for Government to “support the role that venture capital can play in driving growth in the indigenous economy, by ensuring a stable, long-term funding landscape" and we are keen to work with them to encourage private capital away from passive assets to fund the future of Irish Industry and the productive assets that will rebalance the economy for generations to come."

Impact of venture investment

She said that research undertaken by DCU at regular intervals over the last 15 years highlights the outsize impact venture capital backed firms have on the Irish economy.

"The last cohort studied contributed 40pc of the indigenous SME spend on research and development in 2016. These companies grow both sales and employment on average 15 times faster than those in the wider SME economy.

"This contribution is more striking considering the number of venture-backed portfolio companies in Ireland at any one time, this is on average just above 100. The aim of our industry is to increase this number to power Irish economic development. This aim has consistently been held back by the lack of private capital in Ireland, and in recent years low seed funding levels.

"There are many reasons for this - the relatively recent nature of Ireland's prosperity, and the roots in an FDI-orientated open economy have resulted in a lack of depth in the type of institutional and corporate investors often seen in other European countries. There is a lack of domestic multinationals, which in other countries, typically deploy some assets in domestic venture capital funds or direct investment in start-ups. In 2018 corporate venture capital activity in the United States represented 52pc of total venture capital investment. Additionally, Ireland has significantly less well-developed family office and endowment fund structures than other European countries, and the small size or property focus of most domestic pension funds has limited investment by in domestic private capital.

"The general trend of moving from defined benefit to defined contribution pension schemes has also meant those of a sufficient scale to have invested in the past (An Post, RTE), find it more difficult to do so now. In practice the EIIS scheme has encouraged investment in asset-backed medium sized companies and extraordinarily little funding has flowed to higher risk innovation driven enterprises.

"Lastly, Capital Gains Tax measures in Ireland are a significant disincentive to building a culture of serial entrepreneurship, diminishing another supply of private capital which exists in other jurisdictions."

Does Ireland need a super Fund of Funds?

However, Larkin believes there is light at the end of the funding tunnel. "The Government are also committed to establishing an auto enrolment pension scheme. Historically the operation of a pension fund holds that the long-term savings of today's workers to be invested in businesses, providing more jobs, and generating tomorrow's profits. The UK Government created the National Employment Savings Trust (NEST), as the default home for pension contributions under auto-enrolment, it currently holds, more than £3bn from nearly 7mn members and their employers. A recent analysis of the holdings in Nest's flagship fund shows that all the 10 largest holdings are in US and not UK based firms.

"IVCA members in receipt of State investment through Enterprise Ireland are required to invest in Irish companies. This State mandate should extend to pension funds directly in receipt of Irish state funding or indirectly through tax reliefs.

"The creation of an auto-enrolment pension scheme is an important step to safeguarding the economic security of Irish citizens. It is important that the design of the scheme does not limit the additional economic benefits to the domestic economy that the deployment of significant sums of State money could produce.

"The IVCA believe that any auto-enrolment scheme should ensure that a portion of this pension saving supported by the State should be invested the domestic venture capital asset class and used to finance Irish jobs of the future. An established Fund of Funds will be critical to achieving this aim," Larkin recommended.

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