haysmacintyre

Family Offices and the Tech Industry: Investing in the Future

Technology continues to provide substantial potential returns

The exponential growth of the technology sector over the last decade has generated spectacular returns for those investors with a share in the equity of businesses that have successfully caught the public's imagination, disrupted existing industries and even created new ones.

A consideration of CB Insights' listing of the forty highest returning Venture Capital ("VC") investments shows the result when an investor is able to catch a fabled tech 'unicorn': Swedish firm Creadnum invested $4.5m into Spotify at an early stage, recording an 82x return of $370m when the company underwent an IPO in April 2018. Sequoia Capital enjoyed gross returns of $2bn from the listing of Dropbox and an exit value of $3bn arising on Facebook's acquisition of Whatsapp having been the first venture investor in both.

With success stories like these, it's unsurprising the technology sector enjoys great depth both in the number of new businesses coming to market, and the funding options available to them.

Crowdfunding, peer to peer lending and initial coin offerings are all funding mechanisms that have joined the more traditional private and public routes to capital. Concurrently, lending solutions continue to evolve, with venture debt now seen by some in the sector as a preferable alternative to the dilution that an equity fundraise brings.

Despite a crowded capital market, direct Family Office ("FO") and High Net Worth investment is considered an increasingly attractive source of investment by many tech entrepreneurs. With greater flexibility than a traditional VC firm, FOs are able to take longer-term positions in portfolio companies and are viewed as less likely to insert restrictive clauses into their term sheets such as director fees, onerous convertible loans and over-ambitious growth targets.

Family Offices are attractive tech investors

There is clearly no one size fits all characteristic of an investor, be in a PE or VC fund, FO or business angel. However in the eyes of many tech entrepreneurs, FOs are a high quality class of patient capital that gives them greater freedom to explore commercial opportunities and pursue longer term objectives. Compared to many traditional VC funds, which will have exit-led time constraints and fund restriction criteria, the perception of the technology sector is that FOs take a more holistic view of a business's growth potential, can collaborate better and can act quicker than typical VC funds.

For tech start-ups, these traits make FOs a very attractive proposition. A misconception is that founders and entrepreneurs prefer silent partners who will leave them to run their business, however our experience is they in fact greatly value the input and connections of the right investor and will seek to connect with those who they perceive can contribute to the growth of their business, rather than profiting from it; there is a mutual appetite for investment on both sides.

A measure of this is seen in the scale of investments made. The top three direct FO investment firms count over 350 start-ups in their portfolios, the majority of which are companies with a significant technological aspect.

This is particularly true where technology-based solutions are being applied in a social enterprise context, an area of experiencing high levels of FO interest, given the strong tradition of philanthropic tendencies many have exhibited.

FOs are natural fit in this space, given social purposes business and enterprises' longer term runway of growth and wider measures of success than solely financial metrics. As a result, we have seen substantial direct FO focus on businesses merging digital technology with education, accessible healthcare and sustainable energy. For example, Kapor Capital, an FO with over 190 portfolio companies (source: Crunchbase, March 2018) has a commitment to investing only in businesses that can produce both significant financial returns and social impact.

Due diligence is essential

Capital markets for technology businesses are well evolved. Well-rehearsed, coherent pitches for investment are a given for any entrepreneur. Indeed, many founders anticipate scrutiny not only of their business model but also of their legal and financial history. This scrutiny should form a fundamental part of the process and there are a range of issues that are typically linked to growth tech businesses.

The level of due diligence that can be conducted on a potential investment or acquisition can vary enormously. Earlier stage investments typically tend to result in a lower threshold of due diligence on the assumption that commercial and legal arrangements are less complex, with greater scrutiny placed on the business concept and management team.

haysmacintyre however, recommends a comprehensive legal and tax due diligence exercise should be carried out on any business.

Within the technology sector, two of the key legal risks that arise are in relation to the ownership and deployment of intellectual property. One risk to the investing party is that they are acquiring an interest in an entity which only licenses, rather than owns the IP which is the foundation of its business plan and is therefore at significant risk of losing its competitive advantage when this license expires.

Similarly, it is important to consider the nature of the business's key contracts. Is there a concentration risk with key customers? Are there any onerous exclusivity terms embedded within these contracts which might hinder the growth of the business? Our experience has been that such terms may not always be factored into growth projections or there is insufficient attention paid to the possibility of losing key customers and the impact this has on the business's value.

From a financial perspective, tax issues should also always be considered, even in a start-up or scale-up business. Early stage companies will often incentivise their employees through the use of share options schemes. If such schemes are 'unapproved' by HM Revenue & Customs (HMRC) then there is a risk of a materially adverse impact on the relevant scheme holders should an investment event occur, triggering a large tax bill for both the individuals and the company.

A particular issue facing tech businesses is in the employee versus contractor question. Cases involving the likes of Uber and Deliveroo have been very prevalent in recent years, with tax authorities (both in the UK and globally) putting increasing pressure on disruptors around their use of contractors, which has had a ripple effect across the industry. There is a now a significant risk that regular contractors are in fact judged to be employees, resulting in income and social security taxes becoming due, often backdated a number of years.

International considerations should also not be ignored. One of the key attractions of investing in a tech start-up is the potential for global, rather than domestic growth. This is not without its pitfalls and investors should consider the local regulations businesses are required to comply with and how they have approached these. Financially, sales tax should always be a consideration when international transactions are taking place – in the United States particularly, the recent Wayfair case (where online retailers previously exempt from most sales taxes are now liable, despite not having a physical presence in many states) has demonstrated an ever changing climate which carries substantial risk if, again raising the prospect of back dated tax bills.

Outlook

A key factor in many of the socio-economic, political and regulatory changes that are being felt globally, tech businesses are playing a key role in setting the pace of change, bringing with them significant new investment opportunities.

While the businesses offering the solutions to these changes may be radical innovators, many of the underlying considerations that investors should weigh remain in line with those of traditional businesses.

There is no sign of the current flow of new opportunities abating but investors should remain aware of the risks, as well as the potential rewards.

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We were named 'Audit Team of the Year' at The British Accountancy Awards in 2017 and a top 25 firm in the Accountancy Age Top 50 + 50 2019 rankings.

Sector specialism

Our corporate experts provide a complete compliance and advisory service for all kinds of early stage, fast-expanding and family businesses, as well as AIM and listed companies. We are active members of the Quoted Companies Alliance, as well as being a top 15 auditor to quoted companies in the Adviser Ranking Listing.

International

haysmacintyre is a member of MSI Global Alliance (MSI), which we co-founded over 25 years ago, with the aim that it would support our clients' international business operations and growth plans. Now MSI is the seventh largest alliance of its kind in the world, involving over 250 medium sized legal and accounting firms based across more than 100 countries. Being part of MSI allows us to offer our clients expert guidance and support internationally through working with our alliance colleagues, alongside also being members of the UK trade and investment advisory network.

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