

## Quester VCT3 Plc - A Brief History and Analysis

by R.W.Lawson, UKSA, Revised 16/11/2004

Quester VCT3 was launched in April 2000 and raised £48 million from subscribers. The directors of the company (and there have been no changes since) were: D. Quysner (Chairman), M. Brooke, G.Hayter, A.Holmes and J.Spooner (the latter two are employees of the fund manager, Quester Capital Management Ltd).

Many of the investments made by Quester VCT3 have been made alongside other investments by funds such as Quester VCT1 and Quester VCT2 also managed by Quester. Some comments on each year of the company, extracted from the annual report or otherwise, are as follows:

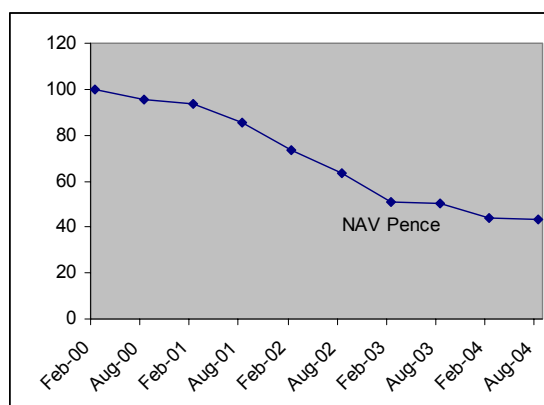
**2000/2001:** The company invested £20.6 million in 26 companies, but by the end of the year two of them had already been written off, including Boxman (Boxman was an on-line music retailer which was one of the largest and most typical failures of the dot.com era). At the year end, Net Asset Value (NAV) of Quester VCT3 was 93.7p.

**2001/2002:** The company invested a further £5.4 million in “attractive investment opportunities ..... at prices that reflected the lower prevailing level of valuations. The majority of companies in the unquoted portfolio suffered from adverse business conditions”. A full provision was made against 5 investments (including PowerX and Linkguard) plus there were partial provisions against a further 8. Year end NAV was 73.7p.

**2002/2003:** “The majority [of companies] were adversely affected by the prevailing political and economic situation. This has resulted in additional provisioning of an aggregate of £8.4 million against the carrying value of 19 companies....”. Full write-offs were made on Assethouse, Optical Micro Devices, Purple House and Purple Technologies. Year end NAV was 50.8p.

**2003/2004:** “During the year there was a marked improvement in the trading and financial position of a number of our more promising investments, but disappointingly, this has not been reflected in the net asset value of your company, which fell by some 13.6%”. The year end NAV was 43.9p.

The inexorable decline in Net Asset Values of the company over the years is shown by the chart below.



A full list of all investments since the launch of the company, showing subsequent realisations, write-offs or current values is as follows (incidentally UKSA would like to see similar lists in all the Annual Reports of Venture Capital Trusts but this has been made up from data supplied by Quester):

### Quester VCT3 Investments

Original Year Invested	Company	Total Amount Invested (£'000)	Current Value (at 31/8/2004) or Realised	
2000/2001	Anadigm	1,278	364	
2000/2001	Artisan Software	1,104	354	
2000/2001	Bowman Power	1,079	50	Written off 2003/2004
2000/2001	Boxman	750	0	Written off before end of year
2000/2001	CDC Solutions	1,000	1,000	Sold 2003/2004 on earn out.
2000/2001	Community Internet	1,015	254	
2000/2001	Elateral	1,873	122	
2000/2001	First Index	1,373	0	Written off 2003/2004
2000/2001	Footfall	1,450	1,450	
2000/2001	Imagesound	1,000	781	
2000/2001	Linkguard	1,000	0	Written off in 2001/2002
2000/2001	On Demand Distr. (OD2)/Loudeye	1,691	1,848	Sold 2004/2005 to quoted co.
2000/2001	Parascan	1,232	0	Written off 2002/2003
2000/2001	Printable Field Emitters	1,440	0	Written off 2003/2004
2000/2001	Purple House	1,075	0	Written off in 2002/2003
2000/2001	Purple Technologies	1,424	0	Written off in 2002/2003
2000/2001	Reqio	1,775	26	Written off almost in full 2003/2004
2000/2001	Ribotargets/Vernalis	965	571	
2000/2001	Sift	875	656	
2000/2001	Assethouse	980	0	Written off 2002/2003
2000/2001	Optical Micro Devices	527	0	Written off 2002/2003
2000/2001	Web X/Innovation Group	810	62	Sold to Innovation Group
2000/2001	Iwix	750	0	Written off 2002/2003
2001/2002	PowerX	1,423	0	Written off before end of year
	Antenova	999	750	
	Anthropics	1,070	70	
	Arithmatica (Automatic Parallel Des.)	1,347	1,347	
	BlazePhotonics	513	32	Written off 2003/2004
	Cyclacel	800	800	
	Lorantis	1,000	625	
	Opsys	1,052	288	Sold 2002/2003 to CDT for shares
	Sterix	630	1,060	Sold 2004/2005
	Teraview	500	608	
2002/2003	Avidex	386	386	
	Casella	804	477	
2004/2005	Allergy Therapeutics	125	125	
		<b>37,115</b>	<b>14,106</b>	<b>Totals</b>

Comments on the investments made, and the results thereafter, are as follows (note that some of the conclusions have been made after a detailed study of the portfolio investments and their history following access given by Quester to such information - individual companies that are still in the portfolio are not discussed here in detail for reasons of confidentiality).

Of the 23 investments made in 2000/2001 (ie. the first year of the company), 13 have been subsequently written off in full, or realised for very small amounts. This is a very disappointing outcome for any venture capital fund. Venture capital funds certainly tend to write-off a number of investments in their early years. To lose 10% to 20% might be the expected range, because however careful one is at choosing investments, there are always a few “duds”. This particularly applies in early stage technology companies, where the product or service may be misconceived, the market uncertain and the management incapable of following through on the business plan for various reasons. To have 56% of the investments subsequently become of negligible value is however unexpected.

Why did this occur? Well it is clear that the fund managers certainly appear to have caught some aspects of the “dot.com” fever that was prevalent at the time. Several of the businesses were internet related and subsequently proved not to have viable business models or real customer demand.

In addition, many of the investments that were made were at very high valuations for somewhat skeletal businesses. Often those investments were made alongside other investment funds (so Quester were not alone in that respect), but the result was that the investee businesses geared up aggressively to establish market positions or mindshare without paying much attention to costs or cash flow. This was very much the accepted approach during the dot.com boom. When prospects later proved to be bleak, none of the investors was willing to fund them further.

There is also the problem that investments were often made in “fashionable” areas such as internet, optical devices for telecoms, java software applications, e-marketplaces/B2B, which often turned out to be less promising than people expected. The decline in telecoms markets when customers stopped buying new equipment hit more than one investment, for example.

The problem of high valuations when investments were made has also affected the investments that remain in the portfolio, where the “up-side” in current valuations for what have otherwise been successful businesses have been quite small, or even negative in some cases. A good example is Footfall which is still valued at it’s original cost even though it has clearly made good progress financially.

Investments in subsequent years (2001/2002 and 2002/2003) have fared somewhat better, although some of these are in the healthcare sector (eg. Cyclacel, Lorantis and Avidex) where valuations can be somewhat problematic for what are early-stage research based companies. It may be some time before the success of these investments, or not, is apparent, and valuations may depend on those of comparable companies rather than underlying financial fundamentals.

One question that should be asked is whether the fund manager actively “managed” the investee companies. In other words, did they interfere quickly enough when things started to go wrong, or businesses were clearly not on track? Was incompetent management changed or companies encouraged to restructure and revise their business plans before cash ran out? Certainly some changes were made, but there is definitely a question mark over whether the fund manager was active enough in this regard (of course the fact that investments made were made alongside other funds and not necessarily as “lead” investors can inhibit and slow such actions).

A more positive aspect of the current portfolio is that it appears that the remaining investments from 2000/2001 appear to have sustainable businesses and the valuations seem reasonably conservative. In some cases there are grounds for optimism on future progress, although it seems unlikely that there will be any rapid increase in the Net Asset Value of the fund, and the downside risk should be limited.

For investments made in 2001/2002 and later years, many are still relatively immature so it may be difficult to forecast future results, but again rapid progress in valuation improvements, seems unlikely.

However, the company still has £6.6 million in non-venture capital listed investments that could be easily liquidated and £1.7 million in cash that could be used to make further VC investments. Apparently some further investments are being considered at present. However the company needs to retain some cash for share buy-backs and of course the dividends on the listed investments (which are apparently relatively high yield) and interest on the cash are supporting the high costs of operation of the company. And of course the company director’s may wish to consider whether they have sufficient confidence left in the fund manager to back their further recommendations.

*Note: The above should not be construed as investment advice or as a forecast of likely future performance of any investment in the company. It is provided purely as an explanation of how the company got into it’s current position and the current status of the investment fund.*

## Quester VCT3 Plc Cost Structure

Another reason for the net asset value being eroded over the years in this company is the relatively high cost structure. The expenses and overheads of running the business far exceed the income from the fund, and with few capital gains, this accelerates the decline in the net assets of the company.

For example, in the last full year, the income of the company was £356,000 but total costs were £959,000 (this compares with £24.2 million of net assets at the start of the year, ie. about 4% per annum). A breakdown of costs is as follows:

Investment management fee payable to Quester: £606,000 (2.5% of assets)

Administrative and Secretarial Services payable to Quester: £43,000

Directors' remuneration: £39,000

Auditors remuneration - audit services: £22,000

Auditors remuneration - non audit service (VCT status monitoring?): £10,000

Legal and professional services: £24,000

Other expenses: £69,000

Irrecoverable VAT (mainly on the investment management fee): £146,000

The audit fees are high in comparison with those of other VCTs. The auditors are KPMG. Other costs seem more in line although a more detailed breakdown as per the UKSA Guidelines would be useful (the above information is simply taken from the Annual Report).

## Quester Fund Management Background

Note that the Quester VCT3 investment fund is managed by Quester Capital Management Ltd which is a wholly owned subsidiary of Querist Ltd. Quester Capital Management also manages the funds of the other Quester VCTs and provides services to them. The revenue in 2004 from the VCTs was as follows:

Quester VCT: £416,083  
Quester VCT2: £621,040  
Quester VCT3: £642,907  
Quester VCT4: £1,047,107  
Quester VCT5: £491,590

The directors of Quester Capital Management Ltd are A.Holmes, J.Spooner, S.Acland, C. Gee, J.Milne, I.Wilcock and M. Williams. The company made profits of £158,715 after tax for the year ended March 2004 which was paid as a dividend to the parent company. In the prior year, the profits after tax were £517,255. The director's fees were nil as they were paid by another group undertaking (presumably Querist Ltd).

The directors of Querist Ltd are also A.Holmes, J.Spooner and S.Acland. The company made profits of £366,789 after tax for the year ended March 2004, after paying £1,562,759 to the directors in emoluments and pension contributions. In the prior year, the profits after tax were £995,125 after director's remuneration of £1,241,464.

The shareholders in Querist Ltd are A. Holmes, R.J.Holmes (same address), J. Spooner, H.D.Spooner (same address), S.Acland, J.B.Milne, and I.C.S.Wilcock. Querist is also involved with other venture capital activities via other subsidiaries in addition to those of Quester Capital Management Ltd. Dividends of £1,318,831 were paid in the year ending March 2004, and £485,833 in the prior year. It is not immediately apparent from the published accounts as to what proportion of those dividends were paid to the directors as there is a dual class share structure.