ICAEW REPRESENTATION 102/17

Financing growth in innovative firms

ICAEW welcomes the opportunity to comment on the *Financing growth in innovative firms* published by HM Treasury on 1 August 2017, a copy of which is available from this link.

This response of 21 September 2017 has been prepared on behalf of ICAEW by the Corporate Finance Faculty and includes contributions from the Tax Faculty, the Financial Services Faculty, and the Business and Management Faculty.

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MAJOR POINTS

Where is capital needed?

1. There is an identifiable need for follow-on investment support for the capital-intensive, high-growth companies in particular sectors. Businesses in emerging industries and advanced technologies find it harder to access finance and, in particular, funding that is committed beyond a three to five year horizon. Such businesses operate in key (strategic) sectors where Britain can build further international comparative advantage. Therefore funding for these activities should form a major part of the UK's industrial strategy.

Replacing European investment

2. The government has an opportunity to direct financing into strategic sectors, to innovative business with the potential to create the biggest long-term benefit. As part of this, investment from the European Investment Fund (EIF) should, on a selective basis, be replaced.

New financial instruments

3. The proposed National Investment Fund (NIF) should focus on supporting strategic sectors. It should offer finance via financial instruments more suited to funding innovative companies (including long-term/venture debt and blended grant/debt funding) and it be staffed by people trained in, or with deep knowledge of, both finance and those sectors. The NIF should provide genuinely new capital, so as not to displace private capital, and with appropriate and structured parameters for investment and return so as to ensure intelligent distribution of public funds.

Increasing take-up of business tax credits

4. Tax incentives do help investment but business take-up. Mindful of the UK's deficit, the complexity of the tax system and Brexit considerations, some carefully structured concessions should be considered which could have a significant impact on firms in strategic sectors, for example to the tax-advantaged venture capital schemes, to the criteria for R&D tax credits and to tax and employment share schemes. Any measures being considered for the purposes of the November 2017 Budget should not create unintended negative consequences for the objectives of this review.

Investment in the right skills

5. Fund managers selected by the NIF to invest in businesses must also demonstrate they have access to relevant industry knowledge and skills before being selected as provider. The government should work with universities and the financial services sector to offer scientific education and research that is blended with grant and private sector finance. This should also include investment management capability so as to create an attractive career path for high quality, future fund managers focused on investing in innovative technologies and companies.

RESPONSES TO SPECIFIC QUESTIONS

Q1 Do a material number of firms in the UK lack the long-term finance that they need to scale up successfully?

6. ICAEW agrees that the evidence – both academic and anecdotal – suggests that the UK may be lagging behind its competitors in terms of long-term investment in high-growth enterprises/scale-up companies. However, the issue is not around the number affected (which is difficult to quantify), rather that there is a gap in financing where a commercial technology, product or service cannot be delivered within five to seven years.

7. Private equity and venture capital deals (including early-stage tech investments and expansion capital deals) in the range of about £5m to £20m are a key indicator of the levels of investment in growing companies that are of sufficient scale to add significantly to the economy, innovation and long-term employment. According to data ICAEW obtained from

Unquote/Mergermarket, the total number of such deals in the UK rose steadily from 62 in 2011 to 101 in 2015, but dropped again, to 76, in 2016. Many of these private equity investments, which are across all areas of the economy, are made on a three-to-seven-year timescale, because of the structure of many of the funds in question.

8. Investment with a longer time span than the typical three-to-five years benchmark used by traditional private equity and venture capital funds is lacking – particularly so, given that the greatest need for new investment is in advanced-technology, capital-intensive enterprises. ICAEW agreed in its submission to the government's Green Paper *Building Our Industrial Strategy* (the Green Paper) that this should be a high-priority area.

9. We do not think that the creation of so-called unicorn companies should be a policy priority. There is little evidence to suggest that the creation of a small number of unicorns is beneficial to the wider economy, long-term innovation or sizeable, sustainable employment. Typically such companies simply leverage existing technologies and infrastructure to disrupt established markets; the most obvious examples being Uber and Amazon.

Q2 Where is the gap most acute by type of firm, stage of firm development and amount invested?

10. As noted in the consultation paper, only particular types of enterprises require patient capital, and in fact, many small companies do not require significant external equity. The pressure for more long-term equity and debt investment is particularly pronounced in emerging technologies and 'industries of the future' (as also highlighted in the Green Paper). These include robotics, AI, data analytics, 3D printing, virtual/augmented reality, new biotech and new materials science.

11. Research by ICAEW and the Institution of Engineering & Technology (IET) published in Boosting Finance for Engineering & Technology (September 2017) highlighted that many advanced-technology businesses needed to diversify their sources of investment, particularly for technology adoption and commercialisation. In the case of many young advanced-engineering companies, this can require significant sums of many millions of pounds committed for as long as 10 to 15 years before the company and/or its technology could be profitable – and therefore begin generating a return for their investors. ICAEW and the IET found that demand for such capital on such a timescale was not attractive for the traditional business models of most quoted investment funds, private equity houses and venture capital firms, so would require the UK government intervention to develop new funds and financial instruments.

12. At an ICAEW/ HM Treasury Business Roundtable, hosted by Andrew Jones MP, Exchequer Secretary, and senior government officials in Whitehall on 18 September 2017 (the business roundtable), ICAEW's Corporate Finance Faculty invited ten founders/CFOs/FDs from high-growth companies from many sectors and from across the UK to share their considerable experience of raising growth finance of many kinds. There was a consensus that the gap is most acute for

    - follow-on capital (Series A) of £1m-£3m in some cases, while in others, up to the low tens of millions (£20m-£40m) to go into production, export or deliver; and

    - in emerging industries and advanced technologies with any or a combination of characteristics including lengthy pre-revenue and production periods, R&D-intensive and capital intensive products.

Q3 Have we correctly identified the UK's current strengths in patient capital?

13. The many equity crowdfunding platforms now operating in the UK have played a part in boosting start-up activity, particularly in sectors where business models can be easily understood and fundraising complements start-ups' own marketing efforts (such as consumer

products, video games, entertainment, restaurants/hospitality, online retail). But the impact is much more limited, even negligible, in advanced technology sectors that tend to require substantial investment of patient capital. Experienced and dedicated angel investing is more common in this space although again it is less common than investment by business angels in proven products or services which require limited capital for start-up or scale up.

14. The continuing role of many venture capital trusts in financing early-stage and growth companies is acknowledged. There is already a need for VCTs to build sector skills relevant to the businesses they back, both in-house and in the pool of external parties they help bring in to those businesses.

15. The range of UK public capital markets caters for different business growth stages and ICAEW continues to contribute to current assessments of the ongoing effectiveness of these markets by the relevant regulatory authorities.

16. ICAEW acknowledges the benefit of the tax-advantaged capital schemes, such as SEIS and EIS and the importance of the HMRC scheme for tax-advantaged venture capital schemes and advance assurance. It is possible that EIS would be even more effective in supporting high-growth enterprises in key sectors - not just start-ups backed by business angels - if the criteria of the existing scheme were better aligned to the requirements of the key sectors. See our response to Q4.

Q4 In what order would you prioritise the UK's weaknesses in patient capital?

17. We think that weaknesses should be tackled relative to the potential benefit of that intervention to deliver sustainable improvement.

18. The first weakness. A comparison with the availability of later stage funding to US companies can be problematic both due to the size of that market and its historical attitude towards risk and return. A more granular review of the differences might provide meaningful insights for remedial intervention, but would require time and cost.

19. The second weakness. There is evidence, eg from business and the angel community, that a focus on key sectors and the development of geographical clusters with a density of principal participants, are vital components for financing, commercialising and generating positive returns from innovative businesses. The Green Paper highlighted that follow-on funding should be in emerging technologies and key sectors, which would include new ventures and technologies emerging from the Industrial Strategy Challenge Fund, the Catapult programme and from key industrial and advanced technology clusters. Established clusters, such as those in the Green Paper, should be priority locations for the skills investment discussed in our response to Q24 and in paragraph 5.

20. The third weakness. The effectiveness of the role of the UK's public capital markets in supplying finance to suitable companies, is already being assessed by regulators such as the FCA (DP17/2 and CP17/4) and the London Stock Exchange (AIM Notice 46), however the need for government measures is not yet clear.

21. The fourth weakness. Strengthening the market in long-term and venture debt would contribute to a mix of more appropriate capital instruments for innovative businesses. The proposed National Infrastructure Fund should [offer] a range of financing, on compatible terms, to help minimise businesses facing competing pressures from different capital sources.

22. A report by BDO and the CBI, Stepping Up, highlighted that 'reduced availability of longer-term debt (loans with terms longer than five years)' is a barrier to businesses boosting their productive capacity. Moreover, research from ICAEW and the IET mentioned above also highlighted the growing role – and even greater potential – of 'venture debt' in UK capital-intensive, pre-profit but 'intellectual property-rich' companies. The experience of ICAEW members at the business roundtable confirmed the usefulness of venture debt received.

23. The fifth weakness. Certain government interventions could be fine-tuned so as to better support growth of innovative businesses in key sectors. For example, small adaptations could be considered to the criteria in tax-advantaged venture capital schemes, such as for EIS, a lengthening of the holding period and an increase in the overall cap and annual limit, and for VCT, an increase in the permitted age of the business and more flexibility in the nature of the transaction. An assessment of the continuing appropriateness for strategic sectors of the criteria for R&D credits, together with better promotion, could be transformational to the financing of those sectors.

Q5 What are the main root causes holding back effective deployment of and demand for patient capital?

24. Many factors can cause demand for patient capital to be held back – some are sector-specific while others are general. The first is a lack of awareness or understanding of different types of finance, including government support. Intelligence from ICAEW's Business Advice Service (BAS) corroborates this, particularly regarding the differing applications of debt and equity finance. This results in businesses seeking debt finance when equity would be more appropriate to their circumstances and this could be avoided if more businesses sought advice or guidance by way of free services, such as BAS and others.

25. The second factor is that it is hard to access a bank loan without security and it is extremely difficult to find a term loan of longer than five years for early stage business. Often business owners will not entertain diluting their ownership by considering equity finance.

26. Another factor limiting demand is that businesses are often not willing to pay for professional advice. This is illustrated by statistics from the SME Finance Monitor, a twice yearly survey of SMEs published by BDRC for UK Finance. This shows that only 7% of overdraft applicants sought advice before making their application and only 18% of loan applicants sought advice before making their application. This means that SMEs may give up after an application for debt is rejected.

27. The absence of a transparent channel linking technology transfer departments, start-ups and different models of patient capital can suppress demand. In some cases this problem has been resolved for example by the University of Cambridge, which has raised a total of £10m since 2012 by the university's commercialisation arm, Cambridge Enterprise, and the creation of the Cambridge Innovation Capital follow-on fund. For a number of reasons, such patient capital models may only be feasible at certain universities.

Q6 What are the main barriers holding back effective supply of patient capital by major investors?

28. ICAEW members at the business roundtable who had received patient capital from outside the UK identified the following reasons for finance not being forthcoming from UK providers:

    - lack of investment mandate or risk appetite to invest in a pre-revenue/ pre-profit business;
    - the business's financing requirement was too high (including when needed for capital expenditure);
    - limited understanding of innovative technology and/or its commercial potential.

29. Angel and venture capital investors, including ICAEW members, refer to poor expected returns from such investments as well as to the impact to restrictions on investments hitherto permitted in the VCT regime.

30. Also, over the past decade, changes to the investment model of insurance companies and pension funds has moved them away from long term equity investment, especially if unquoted.

Q7 Which programmes (investment programmes, tax reliefs and tax-incentivized investment schemes) have most effectively supported the investment of patient capital to date?

31. Feedback from ICAEW members, including during the business roundtable, indicated access to patient capital was enabled through one or more of: Innovate UK, Regional Growth Funds, tax-advantaged venture capital schemes, R&D tax credits, and the Advanced Propulsion Centre. They also cited tax and employee share schemes as effective motivators.

32. Additional analysis is needed to compare utilisation for each programme against a measure for expected eligible businesses/ investors. Published statistics do not necessarily provide this. For example, the Research and Development Tax Credits Statistics (September 2017) reveal that in 2015-16 the total number of claims for R&D tax credits rose to 26,255, an increase of 19% from 2014-15 and that the total amount of R&D support claimed rose to almost £2.9bn in 2015-16, an increase of £470m (20%) from the previous year. While the year on year increases may mean that businesses are becoming more aware of the relief and/or that businesses are becoming more innovative, the absence of a benchmark for eligible claims, against which the performance can be compared, renders the statistics less useful for assessing the effectiveness of the relief. Awareness of such credits might be increased if this was incorporated into the corporation tax return. The government could work with the private sector and use technology to achieve wider dissemination. The business finance guide, produced by ICAEW and the British Business Bank, explains the different forms of finance and has been distributed to over one million UK businesses and advisers so is a good example of such cooperation.

33. We would also encourage the government to undertake an assessment of the comparative effectiveness of interventions, such as tax reliefs versus government grants.

Q8 Are there areas where the cost effectiveness of current tax reliefs could be improved, for example reducing lower risk ‘capital preservation’ investments in the venture capital schemes?

34. The smart focusing of tax reliefs to encourage the supply of capital that would not otherwise be available is most likely to ensure the relief is cost effective. Crucially the administration and recordkeeping required of businesses must not be burdensome. Promotion also is crucial to ensure eligible businesses take up the reliefs.

Q9 Are there other ways the venture capital schemes could support investment in patient capital, in the context of State aid restrictions and evidence on cost effectiveness?

35. We have no comment.

Q10 When is it more appropriate for government to support patient capital through investment rather than through a tax relief?

36. Direct investment may be more appropriate where it is government policy to promote investment in a specific geographical area or industry / strategic sector and at the scientific, pre-commercialisation stage.

37. ICAEW was very supportive of the creation of the British Business Bank and a significant contributor to Tim Breedon’s report *Boosting Finance Options for Business*. ICAEW has also welcomed the steady expansion of Enterprise Capital Funds as well as the £400m of additional funding recently committed by the British Business Bank to its VC Catalyst programme.

38. However, given that there are forms of financial and practical support for high-growth companies, including the provision of support in kind, generous fiscal incentives, grants, loans and equity investment, the government should commission research into the complex – and crucial – interplay between public-sector investment, indirect public support via the tax system and private capital.

Q11 Is there an optimum minimum length of time of investment for entrepreneurs and investors to focus on the long-term growth of their company and, if so, what is it?

39. The optimum investment holding period should ideally be aligned with the expected business development cycle. There is not likely to be a universally representative length of time for all sectors and, to an extent, it would be arbitrary.

40. However, ICAEW members mentioned in the roundtable that the three year limit for EIS investors can result in a “cliff edge” in sectors that could be considered strategic and that these rules were themselves creating a hurdle to patient capital investment. More grounds for an increase in the time limit can be found in the high-level analysis performed by Funding London on 24 companies invested in by its London Co Investment Fund (LCIF), that co-invests private and public money. The analysis indicates that seven years would be the minimum period to focus on long-term growth. Funding London also runs the MMC London Fund, which is a scale up fund, for which it considers the optimum minimum investment horizon to focus on long-term growth to be five to 10 years.

Q12 What other steps could government take to make current tax reliefs more efficient and effective, to provide the best support in line with their policy objectives?

41. See our responses to Q5, Q7 and Q11.

Q13 What scale of new investment should the government seek to unlock and over what timeframe?

42. We have no comment.

Q14 Should resources be focused on one intervention (e.g. a single fund of significant scale) or spread over a number of different programmes?

43. We highlight five general interventions in paragraphs 1 to 5.

44. In terms of interventions for channelling funds, visibility, simplicity and accessibility to businesses should be key considerations.

Q15 When considering how to replace EIF investment if the EIF were no longer an investor in the UK, to what extent should the government seek to replicate the EIF’s current activities in (a) venture capital and (b) private equity?

45. ICAEW supports the government’s aim to replace at least some of the current investment provided by the European Investment Fund that would no longer be available once the UK leaves the EU. This is time sensitive and must be done without an interim period so as to avoid uncertainty or, worse, cessation of operations.

46. ICAEW would particularly support replication of those EIF activities that have underpinned private investment in UK early-stage, high-growth/scale-up as (as defined by Eurostat and OECD in 2007) and mid-sized companies (EU defined as ≤ € 50m turnover, ≤ € 43m balance sheet total, up to 250 employees). The effect of not replacing EIF investment with similar programmes will provide an opportunity for US and EU-based investors to attract and displace UK high-growth companies as part of their investment strategy. ICAEW can provide case studies where this has occurred.

Q16 Beyond replicating existing EIF investment if required, what areas should government focus on to increase investment in patient capital?

47. As set out in answer to Question 4, ICAEW believes that the priority to boost long-term, follow-on funding should be on emerging technologies and key sectors as highlighted in the government’s Industrial Strategy.

48. ICAEW agrees with the review's recommendation that it would be preferable that government investment in a new public-private investment vehicle should be *pari passu* with private investors.

49. There are other features of the EIF approach for the government to consider. The EIF does not publish its venture capital returns, but any fund incubated in the BBB must be transparent. On the other hand, ICAEW members report that their experience of the EIF included a stringent diligence process and an in-depth understanding of the particular technologies being funded. Both these should feature in the approach of a National Infrastructure Fund.

Q17 When considering how to support increased investment, should the government consider supporting one or more of the setup of a public-private partnership, a new incubated fund in the BBB to be sold in part or full to private investors once it has established a successful track record and a series of private sector fund of funds to invest in patient capital?

50. Each option considered needs to have clear parameters, including objectives, remit and timescale which would genuinely lead to an increase in the variety and supply of funding to innovative businesses. We are particularly concerned that such a fund should not simply flow into lower risk investment opportunities and “crowd-out” existing areas of the funding market which are already well served by the banks, by private equity and the capital markets. This would be evidenced by transparent reporting of the key characteristics (term, form, yield etc.) of the investment instruments used and the nature of the operating activities of investee companies.

51. In the case of a new public-private partnership, there need to be transparent conditions for exit.

52. For a new fund incubated in the BBB, it would be essential that a wider set of fund managers be supported by the BBB. For example, the Enterprise Capital Fund (ECF) model could be used with a more focused investment strategy, defined by the BBB rather than by the managers, to focus on patient capital investments.

Q18 If desirable, what steps should government take to encourage investors to form a new public-private partnership to increase investment in patient capital?

53. This form of partnership already exists; for example in the form of LCIF, which invests capital from the Mayor of London and the private sector, and the Angel Co Fund, which invests capital from business angel syndicates and the British Business Bank.

54. Any new partnerships should concentrate on the specific areas where gaps in patient capital have been identified. They should be subject to open consultation to assess the key private sector collaborators, ascertain the outcomes of such partnerships and identify the best organisations to take on board in future programmes. Findings should be published to support applicants understanding of the investment landscape and variety of programmes or methods of working with public institutions.

Q19 What steps should the government take to support greater retail investment in listed patient capital vehicles?

55. There are already tax incentives and a degree of choice of listed patient capital vehicles for retail investors (investment trusts specialising in private equity, VCTs). Access to these includes via Self Invested Personal Pension (SIPP) in a DC scheme, or low-cost platforms.

Q20 Will focusing resources on increasing investment provide better value for money than changes to the tax environment?

56. This depends on the intervention, the degree of incremental capital provided, expected take-up, factors affecting the cost base to administer tax changes, etc. In general, certainty of tax

policy and regulation as well as lack of complexity, encourage both individual and corporate investment.

Q21 Beyond measures already being considered to support more effective asset allocation decisions by DB pension funds across their portfolio of investments, what further steps should be taken to support investment by DB pension funds in patient capital?

57. We have no suggestions.

Q22 How can individual DC pension savers be best supported to invest in illiquid assets such as patient capital?

58. Individual DC pension savers already have access via listed vehicles. It is not appropriate to depend upon this population to plug gaps in the supply of patient capital other than on a pooled basis.

Q23 Are there barriers to investment in patient capital for other investors that the government should look to remove?

59. After the UK's departure from the EU, the government should reassess the tax advantaged venture capital schemes, most notably the restrictions that now apply under State Aid rules and that have significantly limited the application of VCT funds for investment in companies seeking to scale up.

60. The government could support the development of basic standard subscription and investment documentation to assist potential individual investors who might otherwise be disincentivised by the relative cost and complexity associated with bespoke legal documentation.

Q24 What steps should government take to support the next generation of high potential fund managers to develop their knowledge and skills and to raise their first or next fund?

61. Key or strategic areas for the UK involve disrupting markets and emerging technologies, all of which draw upon specialist knowledge. There has been much recruitment of STEM graduates by the financial services sector in the past three decades, so there should be an established pool of individuals with STEM and financial knowledge. Such knowledge needs to be available in fund managers raising and deploying capital and the government has an interest in supporting relevant education and development of career paths for future fund managers. Public money could support centres of investment expertise and fund management excellence at universities. Investment in skill should be aligned with strategic geographic clusters, starting with established ones referred to in the consultation paper.

Q25 What further steps, if any, should government take to increase investment into university spin-outs specifically?

62. Any support targeted at university spin-outs (or other forms of knowledge transfer) could focus on commercialisation of intellectual property within agreed timeframes (eg from five to 15 years), possibly with 'use it or lose it' provisions. Regional support should be aligned with strategic geographical clusters.

Q26 What further steps should be taken to increase investor capability in the public markets to invest effectively in firms requiring patient capital to grow to scale?

63. None, pending the outcome of the reviews already being carried out by the FCA and London Stock Exchange and which can be considered together with findings from initiatives at European level under the Capital Markets Union project, to which UK market participants have made significant contributions.