ScaleUp Institute Response to: Financing Growth in Innovative Firms Consultation

The ScaleUp Institute welcomes the Government's focus on Financing Growth in Innovative Firms with the recognition of the existing and potential value that scaleups – the UK's fastest growing firms – bring to the UK economy. We equally endorse the Government's attention to scaleups within the Industrial Strategy Green Paper, and the establishment of the ScaleUp Taskforce.

Scaleups exist across the country and across all sectors. Increasing the number of firms reaching scale has the potential to deliver hundreds and thousands of additional jobs and billions to the local economy. Evidence shows these businesses are also highly productive, innovative and international[1].

The key now is to turn consultation into targeted, appropriate and measured action which achieves the outcomes we all strive for: namely to make the UK not only the best place to start a business but to scale one. This requires deep pools of connected capital, available through the life cycle of a business to reach global scale, sustained growth and longevity, at the same time as attention to the talent, skills, market access and infrastructure so critical to scaling up.

In a global landscape which is not standing still, many countries and regions - Brazil, Canada, Singapore, Europe - are turning their attention to scaleups as a means of economic growth. If the UK does not align our resourcing effectively to our fastest growing businesses we run the risk of falling further behind. The Government must not only implement recommendations that emerge from this Consultation but those that emerge from the ScaleUp Taskforce and Entrepreneurial reviews if we are to address the stated intent of this review "*to encourage the development of young innovative firms … … and ensure they grow to maturity in the UK [and] fulfil their full economic potential*"[2].

The need to address the issue of long-term 'patient' capital within the UK is not new and has been tackled in successive reviews from Cruickshank[3], to Rowlands[4] to the 2012 Breedon Review[5] and the 2014 Scaleup Report on Economic Growth.

As a consequence, much has moved on in recent years in addressing some of the long term 'market/structural failures' identified in these reports, such as the establishment by the major banks of the Business Growth Fund (BGF) with its regional offices; the set up of the British Business Bank (BBB); the flourishing of the UK angel investment market; the creation of the Small Business Act; the Fintech revolution supported by the UK regulatory environment etc. These have all been positive measures which have placed the UK in a stronger more plural and diverse finance market than has previously been seen.

That said, vital work remains to be done in unlocking UK Institutional funding to our fastest growing firms to create a depth of UK based, long term capital that is ready to invest in cycles of 10 years + and capable of multiple follow on. Scaling businesses consistently cite challenges arising in finding patient 10yr+ investors for series B and above, which is why they often turn to overseas markets. History tells us that there is no 'silver bullet' that can solve the challenge, but rather a blend of different and complementary initiatives will need to be adopted and adapted in a timely manner. Resources should therefore be focused on a number of interventions across a number of different programmes.

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1 SME Finance Monitor: The Scaleup Perspective - ScaleUp Institute, July 2017, and http://www.scaleupinstitute.org.uk/wp-content/uploads/2016/11/infographic_scale_up_review.pdf (Accessed 20/09/2017)

2 Financing Growth in Innovative Firms Consultation - Forward by the Chancellor of the Exchequer (p3)

3 Competition in UK Banking, a report to the Chancellor of the Exchequer - Don Cruickshank, March 2000

4 Rowlands Growth Capital Review - Chris Rowlands, November 2009

5 Boosting Finance Options for Business - Tim Breedon, March 2012

Flexibility alongside investment scale will be key, as will collaborative engagement across Regulators, senior Finance Industry leaders and Government. Maintaining and building upon what works today will be crucial.

With the Brexit dynamic and emerging sentiment of our fastest growing firms that the UK is going to become harder environment to scale[6], it has never been more important to make sure the UK is 'match fit' for scaling up. This means not only building out the finance options available but, in tandem, the skills, leadership and markets access so critically needed for our fastest growing businesses.

Instilling confidence in the future to invest both at a business and investor level is equally crucial at this juncture. The Government must use its response to the Consultation and forthcoming Budget to signal that to fullest effect.

Of course supply is not the only issue to address and we must recognise in responding to the Consultation that demand still plays a role[7].

That is why in combination to supply levers, demand levers should be 'encouraged' with the building out of a sustained education to businesses on the options of growth capital, it's benefits and accessibility. This should include the effective alignment of the multitude of resources in Government to an effective relationship management culture, as exemplified in the Scottish Enterprise model, which works to great effect in joining up public and private sector initiatives to its fastest growing companies.[8]

The ScaleUp Institute endorses the work of the Buffini review and HMT initiation of this Consultation including assessment of the issues at play.

In moving the Consultation forward the ScaleUp Institute recommends a series of actions in this paper to be taken forward in the immediate to short term. We emphasise these are not an either / or set of actions - they must all be undertaken in a concurrent manner.

The ScaleUp Institute welcomes the opportunity to provide input through this submission and are happy to assist in next steps. Should you require any further immediate information or discussion then please do not hesitate to contact the undersigned.

Yours faithfully,

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The Scale-Up Institute is a private sector--led organisation that is focused on closing the 'scale-up gap' by creating a supportive public and private sector ecosystem that enables scale-up companies to fulfill their potential. The Scale-Up Institute was created by the private sector following the 2014 Scale-Up Report on Economic Growth. The ScaleUp Institute collaborates with policy makers, corporate partners and educational establishments to make a real and identifiable impact. The Institute is supported by the Goldman Sachs Foundation, 10,000 Small Businesses, Business Growth Fund, Google, the London Stock Exchange, Smith & Williamson and a range of other advisory, finance, research and industry sector parties.

[6] Early indications from the 2017 Scaleup Business Survey - (to be published November 2017)

[7] As evidenced by the SME FInance Monitor: The Scaleup Perspective

[8] http://www.evaluationsonline.org.uk/evaluations/Search.do?ui=basic&action=show&id=530 (Accessed 20/09/2017)

SCALEUP INSTITUTE RECOMMENDATIONS FOR FINANCING GROWTH IN INNOVATIVE FIRMS

1. Immediate term (within coming months): The Government should allocate new funding to the British Business Bank to develop the necessary flexible and scalable substitutes for a UK EIB / EIF that will work with private sector players across debt and equity instruments.

The evolution of the BBB, with additional funding and additional resources, should be developed with immediate effect, to accommodate the flexible offerings that have been available to UK investors and businesses through the EIB/EIF. This funding should be allocated within the upcoming Budget to give confidence and certainty to investors and businesses alike – it is therefore important that the scale of this funding is sufficient to reassure markets. This funding should be flexible and scaleable, to not just address the 'here and now' but the future evolving market trends/dynamics.

The EIB and the EIF have played significant roles in the development of the UK financial services ecosystem over successive years. They have acted as an essential 'cornerstone' to the evolution in the UK of various Growth Capital instruments across debt and equity instruments. The contribution from EIB/EIF in 2016 alone is estimated to be circa £750 million mainly spread across Venture Capital (c£300m); Private Equity (c£200m); and Debt Funds (£155m).

Whilst we will always encourage a continued fostering of European Relationships, with the Brexit dynamics, it is now essential to ensure the UK has the funding capacity to 'step-up' to take on what has previously been an EU capital resource to so many UK FIs and growth businesses.

Given the scale of successive years of funding, filling the gap that is likely to emerge is essential whilst at the same time providing additional capacity for future needs which will inevitably emerge.

The joint initiative between the EIB and the European Commission has also provided vital pools of capital and research collaboration for life science businesses and other innovative sectors under the Horizon 2020 and COSME programmes. As matters evolve and the UK relationship with the EU is clarified, access for UK innovative businesses should be maintained to these schemes, or they must be replicated as part of the UK replacement to EIB/EIF arrangements.

Substitute arrangements for EIB / EIF replacements should be housed within the BBB which has built a successful track record with some key core strengths. Their performance is evidenced by recent Pitchbook data on Venture Capital funds, which shows that the BBB is the largest UK LP and the third largest in Europe (Behind the European Investment Fund and PFA Pension), based upon VC commitments between 2010 and 2017. Their TVPI and IRR returns also compare very favourably to EIF and the private market.

In taking on this enhanced role the BBB's UK and sectoral reach will be essential, to address regional disparities and sector needs. This may lead to specific sector funds (life science, fintech, creative) as well as localised solutions relevant to local gaps which may be in growth debt or equity. Such solutions would have the further benefit of providing further support to the Industrial Strategy. The key will be to ensure the remit of the BBB allows this flexibility and their mandate ensures working with private sector players with strong regional dynamics.

Whilst skill sets will need to be expanded and bolstered the BBB has the fundamentals and market access/credentials to be the effective vehicle for this next stage of evolution.

2. Immediate term (within coming months): Continuation of targeted Tax Relief under EIS/SEIS and the lifting of current time and capital limits on Venture Capital Trusts (VCTs) to allow VCTs to provide appropriate follow on funding for fast growing firms in their portfolios. In parallel, assessment of the removal of stamp duty for these and closed end funds should be made.

The Enterprise Investment Scheme (EIS) and the Seed Enterprise Investment Scheme (SEIS) have unlocked significant capital for early stage growth firms and are particularly important for Angel investment. Approximately 80% of total investment in Angel's investment portfolios were made through these schemes[9]. **SEIS / EIS must be maintained**, and certainty over the structure of these complementary risk capital tax reliefs provided, or investor confidence will be damaged.

VCTs are a proven route to provide growth finance and significant investors in the real economy - the VCTA estimates that companies currently backed by VCTs have created 27,000 jobs and in 2015 its members alone invested £220 million. However, current rules limit VCTs ability to provide follow on funding for scaleup firms who are on a continuing growth trajectory. **Current time and capital limits on VCTs should be lifted** to allow such to provide appropriate follow on funding for fast growing firms. In practical terms, it is clearly immensely disruptive for a fast growing business to be forced to find an alternative/ additional investor due to regulatory barriers. At a time when the Government is focused upon improving productivity removing barriers that prevent that is essential.

We understand the Government may have some residual concerns on ‘capital preservation’, if this is so then this could be addressed in a principles based approach developed in conjunction with the VC industry leaders to ensure a lifting of time and capital limits aligns to Government objectives. Actions could be undertaken to remove the grandfathering of excluded trades, excluding new qualifying investments from contributing to the purchase of freehold properties; and continuing to exclude sectors that do not meet the Government’s aims for innovation.

Consideration should also be given to to assessing the potential to remove stamp duty from closed end funds and VCTs.

<u>3. Short term (across next 12 months):</u> The creation of an 'at scale’ National Investment Fund / Patient Capital Investment Vehicle / Trust(s) to 'crowd in' Institutional and Retail Investors, with the vehicle capable of listing, and operating alongside a substitute EIB /EIF structure.

Releasing Institutional ‘money’ to provide long term, patient capital must be **the key** outcome of this Consultation. Life insurers hold assets of £1.81 trillion and UK Corporates have £500 Billion of cash on balance sheets which could be invested as patient capital. Only 16% of UK Pension Funds are currently invested in UK equities.

We therefore agree that a National Investment Fund (NIF) or Patient Capital Investment Vehicle(s) (PCIV) should be established for the purpose of ‘crowding in’ large scale Institutional Investors, corporates and retail investors. Arguably the UK has always needed some form of long term, fully fledged, National Investment Fund. Concerted effort now needs to occur to create this working with private sector players.

As the Consultation document highlights, there are varying methods by which a NIF or ‘Patient Capital Investment Vehicle’ (PCIV) can be achieved but what is clear is Institutional Investor’s require economies of scale, a portfolio approach with inherent liquidity and a favourable regulatory regime to enable and optimise investment flows. This includes needing the skillsets to invest in fast growing firms, which generally means Institutional Investors are likely to prefer a scale vehicle which deploys to UK growth capital investment firms with the relevant investor skillset, which in turn invest into the scaling businesses.

As such ‘scale to scale’ must be a factor in deployment i.e. the NIF/ PCIV must be ‘at scale’ itself and where investing into funds these should also be at ‘scale’ and capable of regional deployment.

It is likely that several billions will be required, as evidenced by the BGF which was established at £2.5 billion and will require follow on funding itself in coming years. In developing such a vehicle it will be essential / necessary to work with proven existing players such as BGF and Woodford Investment Management, who have the proven capability to take scaled investment and implement / deploy it to fast growing businesses across localities. For example the case of the BGF, backed solely by the banking industry, demonstrates that it is possible to ‘crowd in' significant investors and is a model and

[9] UK Business Angels Association: *A Nation of Angels*, February 2015

vehicle that could be further bolstered through Institutional funders to deliver even further scale to growth businesses. The banking industry backed the BGF when ringfencing was not in place and Government should be alert to the unintended consequence of the ringfence in enabling banks to take on a greater role.

The NIF vehicle must work with the private sector across a range of Investor forms/categories - and must be established in a way that does not not lead to the unintended consequence of stifling an innovative /diverse finance market.

We therefore believe the following set of principles should frame the structure to an NIF / PCI Vehicle(s):

- Flexible and large enough (initial seed capital of circa £3-5 billion of private funding raised) to address the challenges of tomorrow, rather than just those that are currently recognised and present in the current market.
- Able to aggregate the scale of funding from institutional players (>£100 million), and be flexible enough to practically deliver long term later stage funding to UK scaleup and scaling businesses through a selected group of private sector partners.
- Have the ability to address regional challenges in the raising of capital and provide the double bottom line that will be needed to provide confidence in the current investment climate.
- Assess sourcing of cornerstone seed funding from UK Government or Bank of England to work alongside private sector institutions.
- Able to crowd in international funds, family office funds and corporate venture capital.

It will also be necessary to:

- Assess and enable changes that need to be made to capital rules in order to support this endeavour, including adjustment to risk weighting and the impact of Solvency II on Institutional Investment. Capital charges under the Solvency II regime act as a disincentive to invest in equities rather than bonds: on average, the capital charge for equity is double that of debt.
- Reassess tax treatment of equity vs. debt to re-calibrate the fiscal and regulatory system to foster equity investment from a range of institutional players.
- Review RWA treatment for ringfenced banks to review ability for UK commercial banks as a further source of investment.
- Reassess whether an EIS for UK corporate investment would incentivise unleashing of core corporate funding and / or whether a formal agreement with UK Pension and Life Funds to allocate 1% of AUM to UK Funds investing in high growth businesses is beneficial.

In creating suitable NIF/PCI Vehicle(s) lessons should be drawn from the major bank's creation of the BGF which demanded the most senior engagement at industry level to attain agreement of investment commitment and structure, working alongside senior Regulatory and Government levels.

As such, to take a NIF/PCIV forward the Government, in the near term, should create an NIF Implementation Group, Chaired by HM Treasury, bringing together the CEOs of the major Institutional Investors, alongside the Bank of England, PRA, FCA, the British Business Bank, LSEG and leading Funds of BGF and Woodford Investments, who have existing experience and structures that currently support patient capital investment. The remit of this group should be to design the optimal structure for this vehicle and reach agreement on investment commitments which should then be implemented during 2018.

<u>4. Short Term (Across next 12 months):</u> Stimulate demand and improve knowledge of finance among high growth firms, as part of developing comprehensive local ecosystems that are able to effectively support growth in fast growing firms.

The consultation document rightly notes that as well as ensuring sufficient supply, Government must recognise the role of demand in creating a sustainable and adequate source of patient capital in the UK[10]. In addressing demand issues, broader limitations within current ecosystems need to be considered and addressed.

As evidenced by the SUI publication the *SME Finance Monitor: The ScaleUp Perspective* issued in July 2017, recognition of finance programmes by scaleups could be improved. For example, only 24% of scaleups are aware of the BGF, 16% of scaleups are aware of the British Business Bank and 5% aware of the Business Finance Guide. Only 55% of scaleups are currently happy to use external finance to help grow. Over 2/3 (72%) of scaleups will accept a slower rate of growth than get external finance. 53% of never think of using external finance[11].

This shows it will be important to increase the consistency and quality of guidance and education on growth capital finance. This should include the development of a digital platform by which scaling businesses can readily understand opportunities locally and nationally, and should be part of a joined up approach leveraging the programmes that can help them in their journey, and work alongside current business support infrastructure such as LEPs, Growth Hubs and the British Business Bank. As part of this process, the effective alignment of the resources in Government to an effective Relationship Management structure focused on scaling businesses, as exemplified in the Scottish Enterprise model, should be implemented. This should go across local areas and product specialisations. At local level this could be built within LEPs / Growth Hubs or the Growth Hub resources realigned to a larger scale BBB responsible for a joined up finance and business support framework working with private sector partners. The ScaleUp Institute would be happy to work with Government to develop this further and provide international comparators.

5. Scaling businesses need barriers breaking down, not just in finance but in identification, access to talent and access to markets: the Government should take on board the private sector recommendations under the Scaleup Taskforce on data, markets and leadership and ensure they are taken forward in an appropriate manner.

The Scaleup Institute is very supportive of the Government's Industrial Strategy and this Consultation on Financing Growth in Innovative Firms. Research has shown that scaleup businesses are more international, are more productive, and are more innovative[12]. Whilst our scaleups remain robust around their growth plans regardless of Brexit, they are expressing increased concern about the environment in the UK becoming a harder place to grow[13]. The UK must therefore pull all available levers at a local and national level across public and private sector to support our diverse, cross country, cross sectoral, scaling businesses. The good work therefore underway with the private sector as part of the ScaleUp Taskforce should be taken forward including the essential, more effective use of HMRC / ONS data to identify as early as possible our scaling business; the opening up of procurement opportunities; the better targeting of scaleup export services; the assessment of enhancing a fast track visa system for scaleups based on the Tech Nation model[14]; and the development of local scaleup programmes as part of Strategic Economic Plans, including peer-to-peer networks.

In Conclusion

10 Financing Growth in Innovative Firms Consultation (p34, 4.15)

11 *SME Finance Monitor: The ScaleUp Perspective* - ScaleUp Institute, July 2017

12 ibid.

13 Early indications from the 2017 Scaleup Business Survey - (to be published November 2017)

14 http://www.techcityuk.com/tech-nation-visa/ (Accessed 20/09/2017)

No one silver bullet will address the needs of scaling firms or "*encourage the development of young innovative firms … to foster their ambition … and ensure they grow to maturity in the UK [and] fulfil their full economic potential".*

The consultation on Financing Growth in Innovative Firms must deliver on several fronts most notably the replacement through the BBB of EIB / EIF; the continuation of targeted Tax Relief under EIS/SEIS and the lifting of limits on VCTs; the reassessment of the tax treatment of equity vs. debt; the removal of Stamp Duty from closed ended funds; the reassessment of capital charges under Solvency II regime; and **crucially the formation of a long term National Investment Fund that does release greater UK Institutional and Retail investment into our scaling businesses.**

Equally as part of this the scaleup barriers on talent, leadership and markets, must be tackled and resolved as part of the Industrial Strategy next steps.

We must act now as the global competitive landscape is shifting with many countries placing effort and resources in to supporting their scaling firms, and indeed seeking to attract those who have set up operations here to move overseas.

The ScaleUp Institute welcomes the opportunity to provide input through this submission and are happy to assist in next steps.

Yours faithfully,

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