



**UK Treasury consultation on financing growth in
innovative firms**

**Response from the Chartered Association of Business
Schools**

Chartered ABS response to the UK Treasury consultation on financing growth in innovative firms

The Chartered Association of Business Schools is the voice of the UK's business and management education sector. The UK's business and management education sector represents 1 in 7 university students and contributes £3.25b to the UK economy. Its management students go on to lead global businesses and its entrepreneurs contribute to our dynamic economy. Its research has an impact across society and helps to turn our capacity for invention into viable businesses. Our members consist of 120 business schools and higher education providers, as well as affiliate stakeholders, corporate members and international partners.

The Prime Minister announced in November 2016 that HM Treasury would lead a review to strengthen the UK further as a place where growing innovative firms can obtain the long-term 'patient' finance that they need to scale up.

This consultation forms part of that wider review and focuses on whether a gap in the supply and use of patient capital is holding back more firms from growing to scale in the UK. For the purposes of this consultation, patient capital is defined as 'long-term investment in innovative firms led by ambitious entrepreneurs who want to build large-scale businesses.'

The Chartered ABS undertook to gather evidence on this topic on behalf of the business and management education sector. To this end a survey was distributed to members on 4 September with a deadline for returns of 18 September.

The findings from this survey have been consolidated in the analysis below.

1. Introduction

A clear majority of respondents believe that a material number of firms in the UK lack the long-term finance that they need to scale up successfully. 'Access to capital is always an issue but has become very problematic in the past 10 years because of the UK markets historical and unbalanced dependence on bank finance and the collapse of trust in and supply from that particular source.'

2. Strengths and weaknesses

Most, though not all, respondents believe that the UK Treasury has correctly identified the UK's current strengths in patient capital. One additional strength mentioned was that the UK has a very strong private equity market, which provides an exit to investors as well as access to debt for the firm. Private equity has been paying higher valuations than trade in many sectors for years and is therefore a good option for investors. It is also an excellent option for the founding entrepreneurs who not only have the chance to release some funds for themselves but also retain a high portion of the share capital in the refinanced firm due to the structure of 'sweet equity'.

Respondents had more divergent views as to the weaknesses in UK patient capital - the one weakness most commonly mentioned being a lack of follow-on capital. 'The biggest weakness is in the availability of follow-on capital in sufficient amounts to keep high growth entrepreneurs on board.'

Some feel the dominance of bank finance is an issue with outdated restrictions on direct involvement in the investment process by individuals stymieing a credible, sensible and more diverse source of finance.

3. Funding Gap

There did not seem to be any discernible pattern in respondents' opinions of where the funding gap is most acute in terms of type of firm. In terms of stage of firm development, most thought it was most prominent in the early stages. 'There is an equity gap between £500,000 & £2-3 million. This is between where business angels finish and main stream venture capital investors start. The gap is most acute in early stage firms rather than later stage or management buy outs.'

4. Investment time

Most respondents thought that there is no optimum minimum length of time of investment for entrepreneurs and investors to focus on the long-term growth of their company as this will vary on a case by case basis. In particular, firms operating in different sectors will tend to have different requirements 'This will vary by sector - online digital 5-10 years, software 5-15 years and biotech 15-30 years.' Some respondents did feel that there is a universal optimum length of time and this tended to be around the 5-7 year mark.

5. Root causes

There were differing thoughts around the main root causes holding back effective deployment of and demand for patient capital. Some respondents believe that a major cause is awareness and understanding of how to obtain patient capital. Others felt that the demand for capital is there but the issue is more related to constraints on supply. Some feel that the main issue lies in the quality of the

management team and the business plan and that there is always money around for strong companies with excellent management.

Suggested solutions included:

- Addressing the short-term focus of financial markets by encouraging a different type of market or financial product.
- Moving the tax incentives from when the money is put in to when it is taken out at the end.
- Supporting families to invest in firms.
- Encouraging societal recognition of the importance and value of investors.
- The provision of good quality mentoring for management teams.

6. European Investment Fund

Respondents feel that the European Investment Fund does need to be replaced in some shape or form and that it would be a good idea to undertake a review of its effectiveness as an initial step. It was felt that a fund focussed on the UK only could be more sophisticated or 'sensitive' than the current EIS model and that it is 'too simplistic to place effort behind venture capital or private equity'.

7. Other areas for government action

Some felt that a review of the taxation system would be sensible as it can provide perverse incentives in some areas (e.g. by enabling large post tax gains for relatively modest levels of company growth). Others feel that the tax treatment in the UK is 'wonderful' and tax incentives play a crucial part in encouraging business angels to invest - thus providing very early stage businesses with access to finance which would otherwise be severely restricted.

8. University spin-outs

There were several suggestions for steps the government could take to increase investment into university spin-outs. These included:

- Encouraging the greater availability of funding including the creation of investment funds specifically focused upon university spin-outs.
- Enhance and encourage private sector mentoring for the management teams of university spin out businesses.
- Give guidance to universities on what is best practice in terms of valuation and equity stakes required by institutions. High university stakes on spin outs act to dis-incentivise management teams from either raising enough capital in the first place or accepting follow on finance.
- Get a third-party audit of what university intellectual property could be commercialized across the UK - this would help reveal the size of the opportunity.