HM Treasury consultation

Financing growth in innovative firms

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1. Introduction

1.1. ICAS welcomes the opportunity to comment on this consultation. We are a leading professional body for chartered accountants with over 20,000 members working across the UK and internationally. Almost two thirds of our working membership work in business; others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

1.2. ICAS's Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

2. Key messages

1.3. Supporting investment in risky start-ups through tax reliefs is very effective. At this stage, they provide access to finance and expertise which would not be available otherwise, thus serving a vital role to increase the volume of successful businesses which can move on to VC finance and improving their probability of success.

1.4. We would urge government not to view EIS and VCT reliefs solely as a net cost to the Treasury - they also serve to generate income and employment taxes which we believe outweigh the cost to the Treasury and in terms of timing, provide a positive cash flow for government. These tax reliefs effectively encourage investors to invest in early stage innovative companies that are much more risky than normal stock market investments and therefore performs a critical incentive.

1.5. In our view, to achieve a step change in the supply of patient capital requires leverage in combination with appropriate tax relief. The co-investment model exemplified by Scottish Enterprise who provide match funding has been very effective. We would encourage further development of angel networks in England, supported by a government co-investment fund which replicates this model.

3. Our response to the consultation Questions[1]

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

The stage of development that requires most finance is commercialisation. The prototype has been built and works, but to convince VCTs and VCs to invest, the company needs sales which requires paying for a strong marketing effort. Once the company can prove there is a demand for its product it can obtain finance more easily.

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

The challenge is to get enough companies to start-up and grow. The funding gap is most acute for those seeking £1m to £10m. Such amounts are beyond most angel networks resources yet being at the start-up end of the business growth cycle, the businesses are still too risky for VCs and VCTs to invest in.

[1] Pages 61,62
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/642456/financing_growth_in_innovative_firms_consultation_web.pdf

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

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

Access to follow on capital and the need for more funds during the commercialisation process.

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

Investing in early stage companies is risky. If they succeed, it can take 10 to 14 years to generate a return so it is not a suitable or safe investment for everyone. Very few IFAs recommend it as they lack the skill-set to recommend a particular company and are exposed to a reputational risk if it goes wrong.

A successful means to facilitate and expand these types of investment is to increase the number of angel networks who have the experience to undertake robust due diligence and provide the necessary mentoring and monitoring support to the investee companies following the investment. This provides not only a safer means of investment by relying on the experience of sophisticated investors, it also increases the probability of business success by having access to business angel mentor support.

We observe that there is a proportionately lower number of angel syndicates in England compared to Scotland. We believe that this is inadequate for meeting the potential demand and needs to increase.

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

Supply of capital has increased since the amount of pension contributions have been capped. As mentioned in question 5 above, we believe that there needs to be more angel syndicates, particularly in England. In our experience, syndicates which are supported along the Scottish model backed up with a co-investment fund replicating the Scottish Enterprise model as implemented by the Scottish Investment Bank, has been shown to be most effective. Furthermore, the use of angel networks in Scotland has had a beneficial effect as it increases angel resources, which drives improvements in professionalism, due diligence and education as well as expanding the ability to provide follow on funds and the ability to support a greater volume of businesses[2].

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

EIS and the Scottish Co-Investment Fund have been highly effective in Scotland. They have led to a massive increase in the number of angel syndicates in Scotland, from 2 to 17.

A more holistic assessment of the cost of EIS is needed to give a fair picture of its impact. The consultation paper excludes the additional tax receipts in PAYE and NIC which HMRC receives before the tax relief is paid out. One of our members undertook an exercise with a large angel syndicate which concluded that the government received more in taxes upfront than the EIS relief paid out. The timing of tax receipts indicated that EIS generates a positive cash flow for the UK Treasury.

[2] Multiple advantages of angel syndication also validated through research in:
THE 2014 SURVEY OF BUSINESS ANGEL INVESTING IN THE UK: A CHANGING MARKET PLACE - University of Glasgow

Our impression is that SEIS has had a comparatively small impact which we believe is partly due to its design. The maximum investment threshold of £150k is too low and does not reflect business need. In our experience, very few companies need less than £150k and after the initial injection of £150k, they will need to raise more. Fundraising requires a significant amount of management time, effort and money even when supported by an angel syndicate. We suggest that there is scope for simplification perhaps through consolidating EIS and SEIS. An alternative could be to increase the SEIS threshold of initial investment to £500k to improve efficiency.

Entrepreneurial Relief is most effective if the founder remains with the company all the way through to IPO or exit. However, in many cases they do not and a new CEO needs to be recruited to provide the necessary skills to commercialise the company. In practice, the original founder will most likely still own about 50% to 60% of the company. The right CEO will need incentivised to work for a company with next to no sales and a very risky future. Incentivising through shares is normal practice however the effect of offering a 5% option is too generous if the founders still own 60% of the company. The effect is to dilute the investment for the other investors. We suggest that reducing the 5% to a 2% holding would be more effective in practice.

8. 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?

EIS funds applied by angel groups offer vehicles to lower risk through a spread of investments which can (and do) increase the supply of capital to potential high growth companies in their early stages. Fund managers are however far more risk averse than individual angel investors as they invest other people's money so their focus is on less risky, more developed companies.

There is some scepticism of the crowd funding equity model in this space. This model is inherently weaker than the business angel model at both undertaking robust due diligence and providing wider support of companies they seek investment for. We are concerned that crowd funding is riskier for investors, particularly as the wider group of investors involved includes those with less expertise. There is a risk of poorer investment decisions which could damage the reputation of EIS more widely.

9. 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?

There is some evidence that the restriction on MBO investments is driving VCTs to invest more heavily in the gap between Angel investors and VCs on the same terms as Angels which is very welcome.

The Co-investment Fund provision of 50% leverage has been very effective in Scotland at raising additional finance and should be replicated in England's co-investment funds. We suggest that there is benefit in increasing the maximum investment by the co-investment fund in any one company to £5m. It is on the basis that they do not invest more than 50% in any one round and never own more than 29% of a company which is a sensible approach to modify risk exposure. This would meet a funding need and substantially alleviate the financing problems encountered during commercialisation.

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

As answered in 9 above, when there is a gap in the financing market which normally occurs before companies have proven that they can sell their product in sufficient numbers to justify a VC investment.

11. 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?

Current timescales for a 3-year minimum EIS investment are appropriate. Most start-ups take around 10 years before they get an IPO or the original investors get an exit. Entrepreneurs should be prepared for this. There is little chance in achieving an exit before the widget has been designed and produced and the company can prove there is a demand for that widget.

12. 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?

EIS restrictions on Investor Directors should be eased. Investor Directors bring considerable experience and contacts to early stage companies which take a lot longer than three years to be de-risked. In our view, there is benefit in allowing them to continue EIS investing alongside the investors they represent.

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

The following actions would, in our view, significantly increase the amount of patient capital in the UK:

- Replicating the Angel and Co-investment eco structure in Scotland across the UK to provide a combination of targeted tax relief and leverage. The aim being to increase the availability of leverage through government matched funding (as per the Scottish co-investment model) and increasing the volume of angel syndicates to achieve scale and expertise in the application of these funds as well as improving access to mentoring and experience for the early/growing businesses to improve their success rates.
- Increasing the maximum investment threshold of the Co-investment Fund in any one company to £5m.

The subsequent benefits include an increase in the volume of companies which VCs will be able to invest in.

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

A government backed co-investment fund. Resources should be focused on a regional basis. This facilitates local networking which makes it easier to get to know the business, individuals in charge and who to approach for investment. Archangels' impact analysis shows that the vast majority of companies they have supported remain in Scotland[3] which indicates the success of this type of approach to growing and retaining home grown business in the local economy. The way this is organised in England needs to be reviewed to achieve more even coverage and ensure that the mechanisms for delivery represent good practice and are consistently applied.

Banks and local authorities may not be the best delivery mechanisms either, due to the lack of relevant skills in this particular niche. The Scottish mechanism through Scottish Enterprise works well due to the experience it has built up over many years.

15. 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?

The EIF should be replaced and expanded on in both R&D and Co-investment Funds.

[3] Archangels Impact Analysis of Activities (pg 26)

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

Co-investment Funds.

17. 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?

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

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

We are not convinced that equity Crowd Funding is a safe form of investment in this particular market. Most investors should not be investing in a company that may not produce an exit for 10 years as they lack the expertise to do so safely.

VCTs offer a useful model to access retail investment. It has resulted in the development of several teams of professional managers who can support younger companies in many ways other than just finance (as good angel syndicates do).

We welcome further innovative thinking in this area.

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

21. 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?

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

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

24. 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?

Fund Managers are risk averse and we do not believe this approach is an appropriate way forward for early stage investment. The model needs to be based on informed, experienced individuals taking the risk.

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

If the rest of the structure is implemented (as discussed above in questions 7 and 13) universities will get the investment. Many of the Angel invested start-ups in Scotland are University spin outs.

26. What further steps should be taken to increase investor capability in the public markets to invest?