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Financing Growth in Innovative Firms
HM Treasury (2 Orange)
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Via email: financing.growth@hmtreasury.gsi.gov.uk

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Dear Sirs,

What follows is in the nature of a personal response to the consultation on Financing Growth in Innovative Firms. It is made because of my extensive experience of this area, both as an investor and as a manager of early stage high-growth technology companies (mainly those operating in the software field but also in others).

To summarise, I had a long career in the software industry which included founding start-ups and acting as a director of such companies as they developed, including capital raising (some from EIS claiming investors and VCTs). In the last twenty years I have also made multiple investments in such companies as a business angel which included some where EIS tax relief was claimed. I have also invested in EIS funds and Venture Capital Trust (VCT) companies – for example, I currently hold 17 different VCTs. It is fair to say therefore that I have very extensive experience of the problems faced by early stage companies in relation to capital raising and business development, but also from the point of view of investors in such companies.

I will first give some general comments on the consultation document before trying to respond to the individual questions therein.

It is not totally clear what the purpose of this review by HM Treasury is aimed to achieve. The references to “patient capital” suggests there are some concerns about the fact that smaller UK companies rarely turn into large international businesses despite the fact that they have often developed innovative technology. It is alleged that they sell out too quickly to foreign competitors, or fail to raise finance to grow the business past the middle size.

But there are also suggestions that the Government support to such firms may be poorly targeted in relation to tax reliefs to investors to encourage investment, or by other Government funding programmes.

However there seems to be little consideration of where such firms sit in the global marketplace and the realities of building such companies. Firms founded in the UK are always going to find that after a certain point they are competing with US firms that have a much larger homogenous market for their products and a much more developed and larger capital finance market (both in terms of private equity or public equity markets). Although the Common Market in the EU has removed customs barriers, it has not removed the cultural, language and other barriers to trade across Europe. The result is that it takes longer and is more expensive to develop a market for products in Europe than it does in the USA. Profit margins may also be lower because of the complexity of marketing and distribution in Europe. China and Japan are other large markets with major cultural and other barriers to entry for UK companies. The result of these difficulties means that it is very hard for UK companies to become large international businesses and they are likely to become targets for takeovers by foreign companies. That is particularly so for US predators who will not only have plentiful sources of capital but are likely to value technology companies more highly than they are by UK stock markets – that has been so for at least the last 20 years to my knowledge.

Some of these factors can be tackled by the provision of more equity finance (and it's certainly equity that is needed rather than debt as most new technology companies may have little in the way of assets and hence are not candidates for conventional bank finance).

There is quite good availability of private equity finance but it tends to be somewhat "impatient", i.e. is looking for a return which they can realise in as little as five years. Indeed they may invest on the basis that the company is going to sell out via a trade sale in a few years' time to a foreign public company. Long gone are days when 3i used to be a major influence in private equity investment in the UK where they took a "hands-off" approach to investment and would therefore never push a company's owners to look for a quick realisation.

In terms of public market equity finance, the only major market in the UK for smaller companies is AIM, managed and regulated by the London Stock Exchange (LSE). This has not proved attractive for many companies and AIM has developed a very mixed reputation among both investors and companies looking for a public listing. It has had too many company failures and delistings in the past – indeed ShareSoc, an organisation representing private investors, has run a campaign to try and improve AIM in which I had a hand – see https://www.sharesoc.org/campaigns/campaign-improve-aim-market/ for more information.

Improvement in regulation of the AIM market would certainly help to instil more confidence among investors and companies. Indeed, changes to company law and improvements to audits in general would assist – for example better protections for minority investors in both private and public companies would be helpful. The US legal system provides much better rights and a lower cost of litigation when directors abuse their positions than does the UK.

Other sources of finance have arisen recently such as crowd funded equity or debt, but it is not clear that these can become major sources.

Historically (going back ten or more years), there was a major equity funding gap for smaller companies. The tax incentivised EIS and VCT schemes have helped enormously to fill that gap for companies, although their returns so far as investors are concerned are rather patchy. Taking the first point, the Association of Investment Companies (AIC) have published regular reviews of VCT activities – one published in 2016 is here:
http://www.theaic.co.uk/sites/default/files/hidden-files/AICVCTFeedingthefledglingecomomyOct16.pdf .
It surely demonstrates the success of VCTs, even if some of the investments made by VCTs have tended to be asset based or focussed on more traditional businesses – in other words they have tended to avoid innovative high technology businesses in the past, although the latest rules might change that.

The cause of the investment focus has been the inability of some of the original VCTs that focussed on technology to produce a positive return (Quester and Foresight VCTs in their early years demonstrated the problem). In my view this was due to inexperience in both investing and developing such companies in comparison with say the US environment. Expectations of investors were not met and hence the focus of VCTs was changed by their managers while investors have relied more on the tax reliefs and dividends achieved than on the original expectations of capital growth.

However, it has always been the case that the risk of investment in early stage companies made it essential for tax incentives to be available so far as experienced investors were concerned. This is demonstrated in extremis in the EIS market where my personal investment experience has been very mixed. Most such investments fail or produce no significant return. Although overall I have made profits from them, that's only because two out of ten investments that were made directly produced good returns. EIS funds run by allegedly experienced fund managers have been even less successful. The overall returns have been no better than investing in the FTSE All-Share if one ignores the tax reliefs, and the additional risk would therefore not justify it without the tax reliefs.

The consultation paper suggests that investors might not need the tax reliefs to encourage them to invest in early stage companies but that is not my view.

The paper also appears to suggest that instead of encouraging private investment by the use of tax incentives, the Government might also consider direct funding "on the Government's balance sheet" via an incubator fund as a subsidiary of the British Business Bank. I have to say to you that involving the Government in investment in backing new technology businesses is very unlikely to be successful. It will probably result in backing the wrong horses for the wrong reasons.

With VCTs, if the managers prove incapable, they are either changed, or investor funds get redirected to other companies and their managers who have been more successful. In other words, there is the discipline of the market acting on them. Government funding, unless very carefully structured, is unlikely to achieve positive results. Whether a "public-private" partnership can be designed to avoid such problems, I remain to be convinced about.

It is certainly the case that private investors (who are the primary source of funding for early stage companies via VCTs and other funds) are reluctant to back new funds with no track record. Perhaps there might be a role for Government to take a "seed-capital" role to overcome that difficulty but it would need to be carefully structured. Where public funds are available to co-invest alongside private investors or funds, all it is likely to do is raise the prices that investors will have to pay because companies receiving the investment will realise that it will easy for investors to raise the cash. It might also enable companies to raise more money but in reality the amount they look to raise is more based on the needs of the business and companies will tend to raise the minimum required so as to avoid dilution of existing equity investors.

The focus to my mind should be more on the provision of growth capital to mid-size companies and those operating in sectors where finance is often difficult to obtain in the UK – for example technology companies whose "riskiness" tends to put off many investors. The development of an ecosystem of experienced investors and fund managers in technology businesses, plus advisors with experience of the sector, is an area where Government support can help.

For such companies, improving the AIM market to make it more attractive to both investors and companies, for example by strengthening the regulation of that market would assist in the development of such mid-size companies.

Responses to Consultation Questions

What follows are my responses to each of the consultation questions:

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

Answer: I am not convinced that there is any great shortage of long-term finance for UK firms in relation to the opportunities available to them.

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

Answer: If there is any gap, then it mainly is present in the high technology sector, where innovative new products or services might not achieve funding. That is particularly the case where the funding required is larger in size, i.e. beyond the capacity of private individuals to provide. There are few funds, public or private, that invest in that area because they often consider it risky.

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

Answer: Yes.

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

Answer: See above.

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

Answer: The lack of funds investing in small to mid-size technology businesses is a major problem. The lack of analyst reports and public information on such companies when they are listed is also a problem, and that will be getting worse because of recent regulatory changes. Note that I am not convinced that allowing a "dual share class" structure would encourage entrepreneurs or assist with fund raising. Most wise investors hate such arrangements. Certainly raising more capital via equity placings can be a problem for company management where founders or major investors wish to retain control. This to a large extent comes back to the problem of protecting minority investors – founders don't wish to become minority investors at present because of UK legal difficulties that can then arise.

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

Answer: Knowledge and experience of growth sectors and lack of any technology or science background in such investors is the problem. Unfortunately the UK educational system tends to produce fund managers who have classics degrees and other irrelevant qualifications rather than those with science or technologic backgrounds. Fund managers tend to only invest in what they understand hence the focus on more established sectors of the economy than software or biotechnology.

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

Answer: VCTs have been successful in raising capital for SMEs, albeit sometimes with an aversion to high technology business as covered in my introductory comments. I suggest further changes to the VCT regulations (except to simplify them) should be avoided as constantly changing the rules on such schemes deters investors. Long term commitments, which are required for investment in VCT companies, are going to be deterred if the risk of rule changes in future is perceived to be a threat.

As regards EIS/SEIS reliefs, although these are generous at present I do think a closer examination of the success rate of companies that raise funds using these schemes be examined. I suspect that the tax reliefs provided do not necessarily give a good return in terms of the development of successful, and in future tax paying or employing, companies.

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?

Answer: I suggest that complicating the rules on VCTs to try to inhibit their investment in lower risk assets would simply make life very difficult for the fund managers of such companies, and it would also deter investors from investing in VCTs. It would be better to try to tackle the underlying problem of why they avoid the high-tech growth companies that might provide good capital returns in successful companies to offset the risk of business failures in the losing ones. This is partly a cultural problem in the UK investment scene.

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?

Answer: No comments.

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

Answer: As I said in the introduction, I think it is very dangerous for the Government to provide direct support. The encouragement of investment by individuals or corporate funds by the provision of tax reliefs or other benefits is wiser.

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.

Answer: This is a very difficult question to answer. The length of time one either needs or wishes to hold an investment is very varied. In general my stance has always been that I would be happy to continue to hold an investment so long as necessary and so long as it is making progress. But private investors, who are often elderly, may not wish to hold investments past a certain age, even if business property relief in in IHT is available. Corporate bodies, particularly quoted ones, will not have that difficulty, but they also need to show profitable returns which can only be demonstrated if they have regular realisations. In addition, VCTs tend not to want to hold very large companies. Once they have passed a certain size they become different to the typical VCT investee company and no VCT wants to hold more than a certain proportion of its fund in one company.

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?

Answer: Quicker pre-approval reviews of prospective EIS/VCT investments by HMRC would be helpful. There seems to have been major delays in this area of late which may have caused investments not to happen.

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

Answer: Certainly the focus should be on more institutional investment in "scale-ups" of middle sized companies. This is where the gap lies at present. I am not in a position to advise on the potential size.

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

Answer: Keep it simple I suggest, at least before it is shown that such interventions can work.

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 current activities in (a) venture capital and (b) private equity?

Answer: My impression of the EIF is that it is hardly likely to a fill the gap that I perceive.

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

Answer: See above.

17 When considering how to support increased investment, should the government consider supporting one or more of the setup of a public-private partnership, an 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?

Answer: I would like to see a lot more detail on those proposals before I would support them.

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

Answer: I think investors would be very wary about such partnerships.

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

Answer: I suggest they should consider expanding support for VCTs which have proved to be successful in attracting retail investors. Simplifying the regulations, making them less onerous, and commitments not to change them or tax reliefs retrospectively would help. Perhaps special encouragement for technology investments could be considered, or other “non-asset” based ones to encourage a more entrepreneurial high tech sector would assist.

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

Answer: It is not clear what the purpose of that question is, but I suggest more information needs to be obtained and provided before it can be answered.

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?

Answer: I think it will be difficult to get DB pension funds to invest more in the area where I perceive there is a shortage of funding. One problem is that there is little institutional investment in small listed companies, particularly those on AIM. Institutions are very wary of investing in companies where corporate governance is poor, regulations are often flouted and directors often seem to have little understanding of company law or their duties as directors.

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

Answer: This can best be done by supporting corporate venture capital funds. It is possible for such investors to invest via SIPPs directly in smaller growth companies, but few do because of their lack of knowledge and perception that such companies, particularly those listed on AIM, are risky. Ideally we need listed private equity investment trusts that have a focus on such companies, particularly growth technology companies, but there are very few at present.

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

Answer: Regulation complexity is a likely barrier, as is taxation complexity. For example, the complexity of tax reliefs makes it very difficult for private investors to do their own tax returns if they have invested in EIS and VCT companies. This adds substantial cost, or deters people from making such investments.

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?

Answer: The formation of educational bodies or programmes in existing Business Schools would assist.

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

Answer: More education of academics on what investors are looking for, and a public clearing house of spin-outs looking for investment would assist.

26 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?

Answer: Investor capability (and capacity) will grow if the returns are seen to be there.

Conclusion

In conclusion, let me say that expecting improvements in patient capital investment to be generated primarily from more Government funding, or more tax reliefs, is a mistake when it is the whole ecosystem in which companies and investors operate that is likely to have more influence.

For example, improving public markets such as AIM, reforming company law and audit regulations, simplifying tax relief scheme regulations (for both companies and investors) and improving the education of fund managers and other investors are surely as important.

You are welcome to contact me for further information if required.

Yours sincerely

Roger W. Lawson
Managing Director