Financing Growth in Innovative Firms: the BVCA response to the Patient Capital Review

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For the UK venture and growth capital industry, the Patient Capital Review is an important part of the government's flagship industrial strategy programme. The government is aware of the need to stimulate innovation and growth in the post-Brexit economy and emulate the culture in the US, where venture capital firms are more likely to follow their early stage investment in subsequent funding rounds than in the UK, facilitated by larger venture and growth capital funds.

Background to the review

The Department for Business, Energy & Industrial Strategy (BEIS) launched a green paper on Industrial Strategy in January 2017. As part of this process, the government also announced that it would conduct the Patient Capital Review. An industry panel, chaired by Sir Damon Buffini, was created alongside the Review to help define the key themes for the consultation phase and to provide a package of recommendations afterwards. The aim of the Review was to:

- consider the availability of long-term finance for growing innovative firms looking to scale up;
- identify the long-term root causes affecting the availability of long-term finance for growing innovative firms, including any barriers that investors may face in providing long-term finance;
- review international best practices to inform recommendations for the UK market;
- consider the role of market practice and market norms in facilitating investment in long-term finance;
- assess what changes in government policy, if any, are needed to support the expansion of long-term capital for growing innovative firms.

BVCA feedback and the Government's response

The consultation paper included an analysis of the UK's market for patient capital, where patient capital is defined as long-term investment in innovative firms led by ambitious entrepreneurs who want to build large-scale businesses. The definition includes debt and equity instruments, and recognises that investment horizons might vary by sector, from three to five years in some sectors, to as long as 10 or 15 in others. The consultation also made clear that the Review would only consider changes to the schemes that are consistent with the existing EU State Aid regime.

The government's response to the consultation was set out in the Autumn Budget. The Chancellor announced an action plan to unlock over £20 billion to finance growth in innovative firms over 10 years. The elements of this that are linked to the BVCA's representations are set out below.

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Analysis of the market

Based on a comparison with the US market, HM Treasury estimated that the UK has a "patient capital gap" of around £4 billion per year. This resulted in proportionately fewer innovative UK companies successfully achieving their potential scale when compared to the US. The consultation noted that the UK SME financing market is functioning well in a number of areas and there has been a significant increase in the number of deals involving companies aged less than five years. The paper hypothesised that one of the main reasons for the weaknesses in the market for patient capital is that the capital that flows into the asset class is not being allocated efficiently as a result of a "negative feedback loop" driven by low returns and thin capital markets.

BVCA response – The BVCA report on investment activity and performance measurement survey shows that returns (IRRs) for venture capital funds are improving and that there is also more institutional appetite from UK pension funds. The amounts raised from UK pension funds by BVCA members in 2016 was the highest since the financial crisis at £839 million and 14% of total fundraising. In 2015, this figure was only 6% of the total.

Current Interventions

The consultation paper examined the relative costs of tax reliefs to encourage investment into patient capital and the investment programmes managed by the BBB. The government is making changes to the venture capital schemes to better target them towards high-risk early stage investment, and to reduce their costs. Both in the Review and during BVCA discussions with HMT, the government had highlighted concerns regarding "asset backed" investments and investors not taking the risks the rules were designed to encourage. The paper suggested that government support for early stage investment should come from a mixture of tax reliefs and investment programmes.

BVCA response – We highlighted the value of VCTs, particularly in the context of patient capital, as it is non-cyclical and there is greater certainty over follow up investment. The EIS and SEIS programmes are also of vital importance, as they invest in the very early years of a business' growth and development. We argued that the government should not attempt to reduce the current levels of the reliefs without a fuller analysis of the benefits they bring to the wider economy. The BVCA agreed to work with the government and suggested amendments to address the concerns they had.

Autumn Budget response

- The annual investment limit for EIS investors will be doubled from £1 million to £2 million, provided that any amount above £1 million is invested in knowledge-intensive companies.
- The annual investment limit for knowledge-intensive firms will be doubled from £5 million to £10 million through the EIS and by VCTs.
- Greater flexibility will be provided for knowledge-intensive companies over how the age limit is applied for when a company must receive its first investment through the schemes.
- The Finance Bill 2017-18 will introduce a principles-based test to ensure that the schemes are focused towards investment in genuine high-growth companies and away from low risk investments.
- The government will review these measures to assess their impact on the market.

National Investment Fund

The headline recommendation in the consultation paper was the establishment of a new National Investment Fund, with investment made through the BBB to crowd in additional institutional investment. As recommended previously by the BVCA, this would address the possibility of the EIF withdrawing from the UK market following Brexit. The consultation presented a number of options for how this could be introduced, including a fund of funds structure, a new investment bank or more funding for the BBB's existing programmes.

BVCA response – We recommended further funding for the BBB's existing investment programme. The BBB's scale would become both sufficiently diversified to generate strong returns for itself and private investors, while at the same time investing sums in underlying funds that are large enough to help them invest across multiple stages, particularly the later stage funding rounds associated with scaling up a business. To achieve scale in UK venture and growth capital funds, we must attract more private institutional investment and ensure there is a diversity of funding sources for UK businesses. This would encompass the bolstering of the BBB's funding, continued support for the venture capital schemes (VCTs, EIS and SEIS) and support for private sector fund of funds. We recommended that the government should support all of these initiatives rather than focusing resources on a single intervention. In addition, diversification through investment in private equity could help achieve returns private investors are seeking. The EIF has been an active investor in UK venture capital and private equity funds and the BBB should look to replicate this investment programme where possible. This would include reviewing investment criteria to ensure they are flexible, particularly for funds that invest across the UK and Europe.

Autumn Budget response – The government has announced it will:

- Set up a new dedicated subsidiary of the BBB to become a leading UK-based investor in patient capital across the UK, capitalised with £2.5 billion. It will be set up with the intention to float or sell in part or full once it has established a sufficient track record and in line with State Aid rules.
- Invest in a series of private sector fund of funds. The first wave will be seeded by up to £500 million of investment by the BBB. Up to two further waves of investment will be launched, unlocking up to £4 billion in total of new investment.
- Back first-time and emerging venture capital fund managers through the BBB's established Enterprise Capital Fund programme, unlocking at least £1.5 billion in new investment.

The government also notes that the UK's negotiating position remains to explore the potential for a mutually beneficial relationship with the EIF once the UK has left the EU. Allocation of resources across programmes would be reconfigured if the UK does not retain a mutually beneficial relationship with the EIF.

Increasing effective retail investment

The consultation praised the development of listed funds investing in venture capital as they tend to be large enough to provide substantial amounts of follow on funding and focus on the commercialisation of research developed in the UK. The paper suggested that supporting the creation of more listed funds could help meet the aim of the Review.

The government suggested a number of options, such as the FCA facilitating the establishment of new listed investment funds, or the government providing tax reliefs for investment into listed vehicles.

BVCA response – The government needs to encourage institutional investment into listed patient capital vehicles, and we proposed that institutional investors obtain tax relief of up to 30%, on their other UK dividend income. This would mirror the reliefs available to retail investors in VCTs. This would prove particularly attractive to pension funds and charitable foundations who would be appropriately incentivised to increase their weightings in a higher risk asset class.

Autumn Budget response

- As part of its broader remit, the FCA's new Asset Manager Authorisation Hub will support firms to better understand regulatory requirements around holding illiquid investments, and will hold a dedicated event on long-term investment next year.

Shifting attitudes to investment in patient capital

The consultation noted that the fragmentation of UK pension funds could be a cause of underinvestment in patient capital, and points to existing Department for Work and Pensions (DWP) reviews intended to facilitate the pooling of pension schemes. The consultation paper argued that the reluctance of DC schemes to invest in illiquid assets was driven by market practice where investment platforms used by DC schemes require investments to be priced and traded on a daily basis. It therefore concluded that any attempt to reduce this barrier to DC investment should be industry-led.

BVCA response – As more money has flowed into DC schemes, fund managers have adopted default investment options for their members. Defaults have many of the characteristics of a DB fund as they are managed by professionals and invest across a range of asset classes over the long-term, with specific targets in mind. The BVCA is working with other market participants on this area to develop the necessary infrastructure for DC pension savers. We also argued for the removal of the regulatory “charge cap” of 0.75% that can be borne by investors in default funds that are set up by employers to meet their automatic enrolment duties.

Autumn Budget response

- HMT will establish a working group of institutional investors and fund managers to increase the supply of patient capital, including tackling continuing barriers holding back DC pension savers from investing in illiquid assets
- The Pensions Regulator will clarify guidance on how trustees can include investment in assets with long-term investment horizons, such as venture capital, infrastructure, market-returning investments that have a social benefit and other illiquid assets in a diverse portfolio.

Other measures

In addition to the above, the government has also confirmed it will:

- Back overseas investment in UK venture capital through the Department for International Trade. This is expected to drive £1 billion of investment.
- Carry out a study assessing how to support the next generation of high potential fund managers to develop their knowledge and skills and to raise their first or next fund.
- Identify ways to tackle barriers faced by female-led firms in accessing venture capital through new behavioural research commissioned by the BBB.
- Call on venture capital and other financial services firms to join over 160 other financial services firms in signing HMT’s Women in Finance charter and committing to improve gender balance. The Charter pledges include: setting a target for gender diversity in senior management (which could mirror or exceed those suggested by other initiatives); committing to publish that target and progress made against it on an annual basis; and creating a link between pay and achievement of the target. The government welcomes existing initiatives like Level 20 and Diversity VC in raising awareness of this issue.

In the long term, we hope that the outcomes of this Review promote growth and innovation in a post-Brexit world. A more positive dialogue that is based on mutual trust and a common set of objectives should be a cause for optimism in uncertain times.