Financing Growth in Innovative Firms
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22 September 2017

Dear Sirs,

Financing Growth in Innovative Companies: UKBAA response to the Government's consultation paper on the Patient Capital Review

I am writing on behalf of the UK Business Angels Association which is the industry body supporting the angel and early-stage investment community here in the UK. UKBAA's coverage includes England, Wales and Northern Ireland, whilst collaborating closely with LINC Scotland and Scottish Enterprise. Our membership reflects the diverse base of angel and early-stage investment in the UK, including 70 angel groups varying in size from small syndicates often with a specialist focus to very extensive angel networks with several hundred investor members; 14 crowdfunding and online investment platforms; 25 funds including VC, VCT funds, co-investment funds and EIS/SEIS funds; 25 accelerators and incubators; 45 associates representing professional advisors, corporate finance and other stakeholder groups; and Corporate members including British Business Bank, Scottish Investment Bank, Lloyds Bank and Barclays Bank. UKBAA may thus be seen to embrace the overall ecosystem around early-stage investing here in the UK.

UKBAA's role is to be a voice for the angel and early-stage investment community; to support the growth of angel investing across the UK, especially in areas where the market is underdeveloped; to support standards and quality in angel investing especially through training and the transfer of knowledge; to support access to quality entrepreneurial deal flow; to support access to market intelligence, thought leadership and research; and to connect angels with the rest of the finance ecosystem.

We welcome the Patient Capital Review and its focus on ensuring that small innovating businesses can access the long-term finance they need to successfully scale and grow their companies here in the UK. We agree there are a number of challenges in the current supply chain of finance in this country that are preventing many of our most promising innovators from achieving their full scale-up and growth potential.

We are pleased that the Patient Capital Consultation document recognises the important role that angels play in the supply chain of finance to early-stage innovative firms. However, it is important to note that business angels represent a key source of patient capital, bringing both investment and access to experience and knowledge to support their investee businesses on their growth journey, often through multiple rounds of finance. Most angels make active use of the EIS and SEIS schemes having recognised the benefits of the EIS/SEIS tax breaks to support their investing, enabling them to take risks with their own money to back the UK's innovating small businesses at a very early-stage and where so many other institutional investors would not participate.

We therefore strongly urge the Government to continue to support these tax advantaged venture capital schemes as one of the most fundamental catalysts for bringing private individuals to make investments in high risk innovative small businesses here in the UK. Removing this tax relief would we feel have disastrous consequences for the level of finance available from private individuals to early-stage businesses, resulting in many companies failing to receive the finance they need to start up and build high growth businesses here in the UK. We do however recognise the need for reform to address certain areas of potential tax-advantaged planning and to increase the overall efficiency of the schemes, whilst also recognising that the Government will need to make all adjustments within the framework of State Aid for the time being.

We recognise the need to replace the potential loss of funding through EIF and believe that this should continue to provide a cornerstone for venture capital funds, but consideration should be given to stimulating more private sector co-investment alongside these funds and avoiding displacement of other relevant investment. We support the Government's proposal to establish a new National Investment Fund within the British Business Bank and believe this should provide additional funding to its current programmes. A key aim for this Fund should be to increase the number of larger venture and growth capital funds in the UK by attracting additional institutional investment. This will improve the industry's ability to support companies over the long-term by taking meaningful stakes in businesses over multiple funding rounds, including the larger, later-stage funding rounds associated with scaling up a business.

We have set out below our responses to key relevant questions posed in the consultation paper that are especially pertinent to our community. Our responses below reflect the views of those of our members who have directly fed in their comments and we have also brought a significant number of our angel community to meet with representatives from HM Treasury to discuss the work of our industry and these responses build on this dialogue and the views of our members directly sent to us.

We should be pleased to have the opportunity to meet you to discuss this response in further detail.

Yours faithfully,

Jenny Tooth

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Background on the angel market in the UK

Angel investing has been continuing to grow and represents a vital source of investment for small business across the UK. Unfortunately, it is not possible to have any accurate information on the size of the angel market since many private investors do not provide any data on their investing. However, we are very grateful to the British Business Bank for their support to UKBAA for a new piece of research being carried out on the angel market in 2017 to enable us to have some new data on angel investing and we look forward to sharing this information in the next few weeks with Government to support this current Patient Capital review and the forthcoming Chancellor's Budget proposals, as well as further policy development.

Recent independent research[1] conducted by Oxford Economics on behalf of the BVCA was able to demonstrate the impact of venture capital and angel investment on the economy. Taking account of businesses that had received angel investment over the 5 years to 2015, it identified 15,000 angel-backed businesses in the UK. These angel-backed businesses had a turnover of over £9bn and were contributing 4.5bn GDP and created 69,700 FTE jobs in the UK economy. When also taking into account supply chain and employee spending, the research showed that the sector contributes over £10bn to overall GDP, and supports 140,000 jobs.

This impact far outweighs the amount received by these firms in angel investment and thus clearly outweighs the costs to Government of tax reliefs to support angel investors.

Business angels do not just bring access to capital but are able to bring extensive experience and support to their portfolio businesses, supporting them with strategic issues including business and financial planning and supporting access to customers and markets as well as supporting planning for growth and scale-up.

Angel investment is patient capital. Angel investors are aligned to the company and do not seek to push for an early exit, although from time to time these may occur unexpectedly through a trade sale. Angels are prepared to spend many years in the deal and understand that it can take 10-12 years to achieve high growth or exit.

However, while angels recognise that investing in early-stage businesses is a long-term game, they want to ensure that the portfolio companies they are nurturing at this very early high risk stage can fulfill their growth potential and that they can access the finance they need to successfully scale and achieve high growth. Angels play a key role in supporting the management team to identify the next source of growth finance and seek to create relationships with key sources of growth finance, including VCs and VCTs as well as PE.

The research that UKBAA carried out in 2014 "Nation of Angels"[2] revealed that over 70% of angels

[1] The contribution to the UK economy of firms using venture capital and business angel finance (Oxford Economics & BVCA, available here)
[2] "Nation of Angels" January 2015 commissioned by UKBAA and CFE and carried out by ERC http://3pymgx13iq6338mm7t4caazw-wpengine.netdna-ssl.com/wp-

invest in syndication alongside other angels. This enables angels to pool their risks, knowledge and skills; and by pooling their resources they are able to bring between £100k and £1.5m in first round funding for small businesses. The research also showed that 40% of all deals are done through co-investing alongside other angels, or with other finance sources including crowdfunding, VC and EIS/SEIS funds, grants and loans.

Through syndication angels can bring finance of between £100k and £1.5m per deal and multiple rounds of finance to support the ongoing development of the company. Some of our more experienced syndicates in the UK have the potential to mobilise significant levels of funding, up to £3m, before going on to seek further sources of growth finance. These larger syndicates have shown the capacity to fill the space left behind by many Venture Capital Funds, which now invest at a later, less risky phase.

In addition, the angel market is seeing the development of a growing group of lead angels, many of whom are exited entrepreneurs, or have had very successful business careers at a senior level. These individuals bring extensive knowledge capital and have the capability to lead in identifying deals and in mobilising other investors around them, providing high added value support to the company post investment. At UKBAA, we are seeking to encourage more of these lead angels to come forward into the market.

Angel investing is largely focused around London, Oxford and Cambridge, with a much patchier situation around the other regions and there is a need to build further awareness and capacity for angel investing around the UK's regions. It is important to note, however, that the angel market in Scotland is very well developed, having been supported by the Scottish Investment Bank Co-Investment fund.

In addition, our research revealed that only 14% of all angel investment is carried out by women investors, so there is in this respect a huge untapped pool of patient finance to support UK's growth businesses, especially those led by women founders, and we are working to address this issue and increase the proportion to at least 30% through a two-year campaign recently launched.

content/uploads/2015/09/ERC_Nation_of_Angels_Full_Report.pdf

Responses to the Consultation Questions

UKBAA has responded to the questions that are relevant to the angel market and our role in the entrepreneurial finance ecosystem.

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

Whilst as indicated in the Consultation report, there seems to be a strong supply of start-up and early-stage capital provided by angels, crowdfunders and seed investors, we agree that there are insufficient levels of long-term finance available in the UK to support businesses that have received angel and early-stage capital to successfully access the capital they need to scale-up and achieve high growth. Nevertheless, it is vital to maintain the support of this start-up capital through the EIS and SEIS schemes, or private investors will no longer be in a position to support a pipeline of high growth businesses ready to scale and grow.

We acknowledge the evidence supplied in the Patient Capital Review of the lack of capacity within the current finance supply chain and that more needs to be done to incentivise private sector capital to support later stage companies that are attempting to scale up.

In terms of the question whether a material number of firms lack the long-term finance they need, it is vital to understand the needs of businesses in different sectors. There are certainly key areas where long-term growth capital is required, notably deep science areas such as life sciences and deep technology-focused businesses.

These innovating businesses, which have high growth potential, may be undertaking many years of research and development and testing before the products can be successfully commercialised. These businesses are very high risk for many investors and despite the appetite for angel investors to provide early capital and nurturing and the availability of grants from organisations such as Innovate UK, far more extensive levels of long term patient capital are required to ensure these innovations can successfully reach the market.

However, we are not convinced that these challenges for patient capital are restricted solely to companies in new, high-tech, disruptive sectors. Beyond these knowledge intensive, R&D-focused businesses, there are many innovating companies across a range of other sectors that have extensive capacity to scale and contribute substantially to the UK economy and which may require long term patient capital in order to achieve their full growth potential.

It is also recognised that not all companies will be suitable to scale-up and it is vital therefore that we can target long-term finance to those companies with capacity to effectively scale. Many companies currently receiving early-stage capital from investors will not have the capacity to become high growth and generate the high levels of GDP for the economy.

Q2. Where is the gap most acute by type of firm, stage of firm development and amount invested?

As we have indicated, there is a good supply of start-up capital provided by angels and angel syndicates, with support from some of the early seed funds and co-investment funds, which have been substantially backed by the EIS and SEIS schemes. But to be effective, angel-backed businesses require access to a connected supply of long-term capital. It is imperative that we avoid the "cliff edges" for businesses on their journey from start-up through to successful high growth.

We have identified a significant "cliff edge" in the supply of capital at the point where most angels and angel syndicates reach their maximum capacity, i.e. £2m+, where the investee business may still not be profitable, or even revenue generating and may need more capital to reach a stage of viability or substantial cash flow. Whilst some funds, both VC and VCTs, do state that they welcome angel-backed businesses and are keen to provide next stage scale-up funding, these high risk, non-profit generating businesses frequently do not match their fund parameters. Most funds require substantially less risk, whilst transactional costs for small deals are high and most funds are looking for deals of £5m+. As a result, many of these high-growth-potential businesses will not go on to access Series A level funding.

We welcome the development of some new scale-up funds focusing on working alongside angel investors such as BGF Ventures and Accelerated Digital Ventures and which may be prepared to bring next stage investment in relatively high risk businesses alongside angels, but there is an insufficient number and range of funds available to address the current demand across the UK.

There are also challenges at the interface between angels and VCs and VCTs, which have been created by the EIS requirements in relation to share structure. Angels using EIS tax breaks are aligned with the founders and have ordinary shares, although can take an exit preference, but take no downside protection in their share structure unlike VCs. There could be an opportunity to address this by allowing for angels that are using EIS scheme at the time of negotiating Series A, to have a liquidation preference on similar terms to the VCs, whilst we would not endorse measures to affect the upside or general risk.

We also recognise that those businesses that make it through to venture capital backing and have the potential to significantly scale are likely to have another cliff edge beyond Series D. Notably, the 2016 report published by the Scale Up Institute and Barclays found that, on average, UK companies raised 15% less in Series D rounds and 23% less in Series E than their US counterparts.[3] We also support BVCA's findings that the size of the UK venture capital industry funds is much smaller than in the US, so we clearly need to build the scale and capacity of VC funding here in the UK or we will be losing many of our great scale-up businesses to the US or other parts of the world that have the capability to back the growth of our businesses that we have nurtured here.

In addition, the current size of most UK VC funds is too small to be able to allocate the amount of capital that high growth technology companies now need to be able to grow and scale without

[3] Scale-up UK: Growing Business, Growing our Economy report – available here

running into portfolio % allocation constraints. In general, most funds are unable to invest a sufficiently sizeable amount initially (resulting in management being forever in fundraising mode) and are then unable to follow in size to scale the company resulting in having to exit too early, as has been identified in the consultation paper. To do what is required in today's markets, VC funds need to be able to invest and follow to scale without hitting % portfolio allocation limits.

Q3: Have we correctly identified the UK's current strengths in patient capital?

The EIS framework should be regarded as one of the most cost-effective mechanisms in the UK and globally to stimulate and leverage substantial pools of patient capital to support the UK's high growth potential early-stage businesses. Notably, the scheme has the capacity to attract knowledge capital into the market through cashed-out entrepreneurs and individuals with extensive business experience to bring "smart capital" to support the successful growth of many small businesses here in the UK.

However, we are keen to ensure that the private capital leveraged through this important tax relief is deployed effectively to ensure discerning choices about which companies to back and mobilising added value alongside this private capital. We welcome the chance to comment on the efficacy of the scheme later in this consultation.

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

We believe that there are some substantial challenges for the effective deployment of patient capital. Notably, there is a lack of a joined up supply of private sector capital for businesses across the whole finance ecosystem. Different stages and sources of finance are not effectively working together to share information both about dealflow and about their differing investment parameters, resulting in asymmetry of information impacting on the capacity of high-growth-potential businesses to identify and access the finance they need to support their successful scale-up.

A further challenge for the effective deployment and demand for patient capital is the significant lack of access to a developed pool of angel patient capital outside the London-Cambridge-Oxford triangle, where over 70% of angel investing currently takes place. This was set out in the consultation document, which showed that 58% of equity is deployed in London and the South East according to the British Business Bank's recent research. We are also aware that, of the significant £1.6bn invested through the EIS/SEIS scheme in 2015-16, over 60% of this private investment capital was deployed in London and the South East. Whilst we do have some active angel investment communities operating in the regions outside London and the South East, there is an insufficient critical mass of capital relevant to the needs of growing small businesses in regions. Thus, many high growth potential early-stage businesses seeking equity investment have to find investors in London and the South East.

We welcome the role of the BBB in stimulating further availability of patient capital in the Northern regions through the support of the £400m Northern Powerhouse Investment Fund, of which around £60m will be provided to support equity investment. We are also supportive of the £250m Midlands Engine Investment Fund, of which a proportion will be available for equity investment. Nevertheless it is vital that these new regional funds will focus on leveraging private investment alongside these investments in growth businesses and notably will seek to co-invest alongside angel investors and act as a stimulant for more angel investment in these areas.

A further key challenge in effective deployment of patient capital is information asymmetry, with an acute lack of awareness among many individuals with financial capacity and experience who live in the regions about the benefits and opportunities offered by angel investing to back growth potential businesses within their own local economies. Many individuals are not aware of how to go about backing start-ups or how to be an effective angel investor and make the right choices of which companies to back. This is reinforced by the lack of awareness and understanding about local equity sources among entrepreneurs in the regions, as shown in the recent BBB Report on the Midlands Engine Investment Fund[4], in which it was noted that only 35% of businesses were aware of angel investment compared to 56% in London; and only 13% of businesses could name a business angel or group compared to 29% in London.

Local capacity-building for angel investing: We believe that it is vital for all key players across the regions to work together to support local awareness raising, access to education and direct support to building syndicates, as well as linking to local businesses seeking investment. We propose that this should be a collaborative approach involving the LEPs, local growth hubs, local business networks, key business clusters, accelerators and innovation centres, across the range of finance providers.

Awareness and education for angel Investing: We have specifically identified the need for a nation-wide programme of education and awareness on angel investing to ensure that we can deploy the latent pool of private sector capital across the UK and notably in the regions. Our UKBAA new e-learning angel development programme will be available from October 2017 and will be the first national professional qualification in angel investing. The programme draws directly on the experience of angel investors, offering an in-depth understanding of the process of angel investing, how to evaluate a small business deal and make effective investments and how to bring support and experience post-investment. This is intended to bring much greater awareness, knowledge and skills to individuals in the regions, also bringing advice about how to get involved in angel investing in their locality.

Angel Hubs: At UKBAA we are also developing the concept of Angel Hubs to provide a focal point for building awareness and opportunity for angel investment. We see that these can be physical locations where angels can have space to drop-in and meet other local angels or syndicates; gain access to sources of advice and information on angel investing (for example about EIS/SEIS tax breaks). This will also provide significant opportunity for entrepreneurs to interact with investors, including access to pitching. These hubs will also offer access to a range of tools and support, including e-learning, as well as links to an online showcase of local deals. We see the importance of working closely with local partners and have currently identified the opportunity to launch Angel Hubs in Bristol, Manchester, Leeds, Birmingham and Newcastle, with more to follow.

[4] BBB Midlands Engine Fund Spotlight report 30 August 2017

Sector-specific funds for leveraging patient capital: There are challenges in the effective deployment of patient capital to meet the needs of specific high-growth sectors that need significant levels of patient finance to support their growth and development; and for sectors that may have specific patient capital needs and could seem to be extremely risky compared with other sectors.

We support the opportunity to establish sector-specific co-investment funds to stimulate investment in sectors identified as key growth areas for our economy, which are high risk or potentially underserved in attracting angel and other sources of patient capital. The opportunity should be considered to establish a dedicated co-investment fund designed to stimulate private investors to bring patient capital to businesses in the **life sciences sector**, alongside the Innovate UK grant support for the sector as proposed in the Industrial Strategy Challenge Funds and in the new Strategy for Life Sciences recently announced by Sir John Bell.[5]

Notably, we support the new investor partnership programme being piloted by **Innovate UK**, which provides grant funding support to materially shift the risk profile of investment, enabling private finance to come in alongside Innovate UK grant funding. We believe that this alignment enables lead angel syndicates as well as VCs to come in earlier in the commercialisation cycle.

We are also supportive of a dedicated co-Investment fund to attract investment in businesses with high growth potential in the **creative industries,** since we are aware of the specific challenges for this sector in accessing finance to support scale-up and growth and the need for specific measures to stimulate patient capital, including a dedicated co-investment fund to leverage new angel and private sector investment as set out in the latest report to DCMS from Sir Peter Bazelgette on behalf of the CIC.[6]

Increasing the pool of women angel investment: We are currently failing in the UK to effectively deploy the investment capacity of women with financial resources and business experience. The proportion of women business angel investors currently stands at only around 14% according to our Nation of Angels research[7]. There is need for a diverse base of investors to back small businesses; and the lack of women angel investors represents a substantial untapped pool of patient capital. At UKBAA, we have launched an initiative to increase the number of women investors across the UK to 30%. Our recent research carried out with Angel Academe, an active angel network backing women technology founders, and supported by Cass Business School, identified the barriers for women to become angel investors. The research conducted with over 200 HNW women, both investors and non-investors, has identified a significant lack of awareness

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[5] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/640696/life-sciences-industrial-strategy.pdf

[6] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/646459/2013-E_Creative_Industries.pdf

[7] "Nation of Angels" January 2015 commissioned by UKBAA and CFE and carried out by ERC http://3pymgx13iq6338mm7t4caazw-wpengine.netdna-ssl.com/wp-content/uploads/2015/09/ERC_Nation_of_Angels_Full_Report.pdf

about angel investing among these women across the UK. We will be carrying out further actions for awareness raising and education across the UK regions, but there is much more to be done to access this untapped pool of patient capital across the UK.[8]

Improving access to patient capital for women founders: Increasing the pool of female investment will also have a direct impact on the opportunity for many more women entrepreneurs to successfully access patient capital, since currently there are significant barriers experienced by women seeking investment when the population of investors is largely male. In 2016, only 9% of equity investment went to female founders [9] and only 6% of investment in scale-ups in 2016 was in women-led businesses[10], whilst the Scale-Up Institute's research showed that scale-up businesses founded by women were valued at £3m more than those founded by their male counterparts[11]. Thus, increasing the pool of investment in female-led businesses will lead to many more high growth potential women entrepreneurs coming forward to access the long-term equity investment they need to grow their business.

Q7: Which programmes (investment programmes, tax reliefs and tax-incentivized investment schemes) have most effectively supported the investment of patient capital to date?

We believe that the EIS scheme has been a major driver to stimulate the supply of private investment in high-growth-potential businesses across the UK and specifically to support the deployment of knowledge capital. The SEIS scheme has potentially had the most significant impact on bringing new private investment into the market since its inception in 2012 with its higher level of tax break and has been a strong driver in the growth of crowdfunding across the UK.

We know that many angel investors make effective use of the tax relief schemes to support their investments. At least 7 out of 10 deals are done using the EIS/SEIS schemes according to our Nation of Angels research[12]. However, our research has shown that most angels, whilst very much appreciating the tax breaks to mitigate their risks in backing very early-stage businesses, do not see their decision on which businesses to back being driven specifically by the tax reliefs. Angels see the importance of making discerning decisions on which businesses have potential for growth and scale-up and where they can add value.

EIS/SEIS has played a vital role in attracting private investors with core industry experience and exited entrepreneurs offering strong expertise as well as considerable financial capacity to bring valuable knowledge capital to high-growth-potential businesses. It is vital to ensure that these tax breaks are therefore in place to continue to attract these individuals and that any reforms to the system do not deter such investors.

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[8] UKBAA Women in Angel Investing https://www.ukbaa.org.uk/news/high-flying-women-convene-london-part-drive-boost-number-women-angel-investors/

[9] http://tenentrepreneurs.org/wp-content/uploads/2017/03/UntappedUnicornsFinal-1.pdf

[10] http://about.beauhurst.com/blog/female-founders-data-women-business

[11] http://www.scaleupinstitute.org.uk/research/women-driving-economic-growth/

[12] "Nation of Angels" January 2015 commissioned by UKBAA and CFE and carried out by ERC http://3pymgx13iq6338mm7t4caazw-wpengine.netdna-ssl.com/wp-content/uploads/2015/09/ERC_Nation_of_Angels_Full_Report.pdf

EIS sidecar funds have offered an important opportunity for angel investor syndicates to develop their own co-investment funds using the EIS/SEIS scheme to enable angels to both invest in the fund and also directly into the business. This enables the angel syndicates to bring greater levels of patient capital alongside their investments and increase capacity for follow-on funding.

Of the public investment programmes, we believe that the £100m Angel Co-investment Fund supported by the British Business Bank has been a very valuable stimulant to angel investment and notably to encourage syndication among angels. The £100m Angel Co-investment Fund has brought considerable additional investment capacity alongside angel syndicates in the UK (many of which include investors that have benefited from EIS/SEIS reliefs) and has thus reinforced the opportunity to bring patient capital and smart money especially through lead angels. Since its inception in November 2011, the Angel CoFund has enabled small businesses to secure £172m in investment (as at end Feb 2017). The Fund has invested and committed over £33m, alongside a further £157m from business angels and other investors, providing support for 71 businesses. The Angel CoFund has demonstrated its capacity to leverage a ratio of £1 to £4 from business angel syndicates; and the portfolio companies employ more than 1,100 people in sectors such as life sciences, clean technology, advanced materials and digital technologies.

We recognise the benefit of regionally-focused funds such as the Scottish Co-Investment Fund, supported by the Scottish Investment Bank, which is the most longstanding co-investment fund predating the Angel CoFund. The Fund has stimulated the growth and capacity of a wide number of syndicates across Scotland, significantly increasing the capacity and capability of the angel investment community in Scotland alongside the EIS/SEIS schemes.

The £25m London Co-Investment Fund, supported by the Mayor of London and through the LEP Going Places Fund has also demonstrated good results as a focused regional co-investment fund. Since it was established in January 2015, LCIF has made 110 investments in 91 companies alongside qualified angel syndicates and early-stage fund partners, with a total investment amount of £14.2m, whilst raising a total of £101m alongside, providing a co-investment multiple of 6.15x [13].

A further valuable publicly supported scheme has been the Enterprise Capital Funds, which we believe have brought valuable further scale-up investment, offering opportunities both for co-investment alongside angel investment and post angel investment. These funds, supported by the British Business Bank, bring 2x public investment funds along 1x private sector funds and thus offer a strong leverage to private sector investment.

We especially recognise the impact of the European Investment Fund programme on the supply of VC in the UK. The fund has frequently acted as a cornerstone investor to bring in wider private and institutional investment. We are also aware that over 40% of current VC funds have been supported by EIF investment. We are concerned that the loss of the EIF, if this comes about as result of Brexit, will have a serious impact on the UK's capacity to support patient capital and high-growth-potential businesses and it is essential that this funding is either maintained or replaced by UK public funding such as through the British Business Bank. We are also conscious that there

[13] Funding London LCIF Advisory Board Report September 2017

is already uncertainty about this and that many funds failed to get off the ground this year due to uncertainty over EIF cornerstone funding.

Q8: 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 and SEIS have attracted a huge number of private investors into the early-stage investment market with over 26,000 businesses supported with over £15.9m funds since 1993-4 when it was launched.

However, at UKBAA we acknowledge that this scheme is costly to the Government in terms of taxation revenue foregone, although we do not fully understand the calculations of Government investment in relation to additionality and the specific research done by Ipsos Mori cited in the consultation document since we are not aware that that was carried out among angel-backed businesses. Many business angel investments are in pre-revenue, high risk and very early-stage businesses and thus these entrepreneurs would not have been able to access relevant investment elsewhere that was not also supported by EIS/SEIS e.g. crowdfunding and would not be able to secure debt or loan products.

In relation to the calculation of additionality, it is important to consider the wide scale added value brought by angel investors to their portfolio businesses, drawing on their own business experience to bring support with aspects such strategic planning, access to customers and markets and support with next-stage funding. We draw attention again to the independent research recently undertaken by Oxford Economics for BVCA[14], which demonstrates the impact of venture capital and angel investment on the economy. Taking account of businesses that had received angel investment over the 5 years to 2015, there were 15,000 angel-backed businesses in the UK. These angel-backed businesses had a turnover of over £9bn and were contributing £4.5bn GDP and created 69,700 FTE jobs in the UK economy.

When taking into account supply chain and employee spending impact, the sector contributes over £10bn to overall GDP, and supports 140,000 jobs. In view of the fact that angels use EIS/SEIS for at least 7 out of 10 investments made in small businesses, **it is clear that the contribution to the UK economy made by small businesses backed by angels massively offsets the cost to government of giving these tax breaks to angel investors.**

UKBAA does not accept the Government's claim that the majority of EIS funds have a "capital preservation" objective. However, we do recognise the Government's concerns about this issue and we acknowledge the need to ensure that the scheme is used to mitigate risk and encourage investment in growth-focused businesses that will deliver real growth to the economy, whilst offering the potential for return to the investors. Thus it is important to ensure that the businesses with high growth potential are those being backed under the tax relief schemes.

[14] The contribution to the UK economy of firms using venture capital and business angel finance (Oxford Economics & BVCA, available here)

In relation to SEIS, whilst we have welcomed the impact that this increased tax relief has had in bringing many more investors to back small businesses, there is nevertheless concern expressed by experienced members of our angel community about the prevalence of businesses that are backed under the SEIS scheme that are unlikely to achieve scale or high growth. Whilst some very experienced people with industry knowledge are using SEIS, we are also aware that many new investors who entering the market, some through crowdfunding, lack the skills and knowledge to make discerning decisions about which companies to back and how to identify growth-focused, innovating businesses.

Improving skills for less experienced investors: We believe that we should address the underlying issues of lack of knowledge, skills and experience among SEIS investors as well as some EIS investors. We advocate the introduction of a focused programme of learning with a clear knowledge test for those less experienced investors wishing to use SEIS tax reliefs through crowdfunding platforms or schemes. In this way, we can create a new cohort of much more savvy investors able to make the right decisions on which companies to back rather than being driven by the presence of the tax break. We are willing to work with HMT and FCA and industry players to establish a learning framework and knowledge programme, drawing on our new e-learning programme for new investors.

At the same time, we believe that the Government should not attempt to improve the cost effectiveness of the schemes by reducing the current size of the reliefs or building further complexity into the schemes since this will act as a significant deterrent to private investors and have a massive impact on the availability of angel investment across the UK.

In relation to VCTs, we recognise the role that they are playing in bringing longer-term scale-up capital, but the appetite for risk among these funds is very low. We would also wish to state that many VCTs have shown interest in offering next-stage patient capital funding following angel investment. However, the interface between angel investors and the requirements of VCTs is not functioning effectively. We are aware that there have been recent changes to the VCT schemes and restrictions in relation to company age and development capital and this may have created even more restrictions in the VCT market to investing alongside angel investors. Nevertheless, there could be adjustments made including reviewing the share structure under VCTs to bring them in line with EIS investors; and adjusting their requirements to enable angel investors to have full or partial liquidity of their investment to enable angels to effectively recycle their money into the next wave of high growth start-ups. We believe that many VCTs would be willing to discuss this.

Q9: 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?

Within the current State Aid framework, there are a number of changes that could be adopted that would support further investment in patient capital.

Consideration should be given to using CGT relief to crowd in investors who are not UK income tax payers, but have the financial capacity and experience to invest in high-growth-potential businesses. Individuals who have CGT liability potentially have more time and money to put into early-stage businesses. This could be especially valuable in attracting further private sector investment from outside the UK.

The cap on the amounts that can be raised by firms under the venture capital schemes are also an obstacle to funding scale ups. At present a company may not receive more than £5m per annum, and no more than £12m in total, from the combined venture capital schemes. However, later-stage funding rounds are likely to require significantly more than the £5m currently allowed in a single year – The Scale Up Institute, for example, found that the average amount invested in Series B rounds in the UK was $17m. Finally, the "excluded activities" that are not eligible for tax relief should be re-examined to ensure sectors in which the UK enjoys a comparative advantage are not denied funding.

Whilst the seven-year rule does not apply to many angel-backed businesses, it nevertheless affects businesses in certain sectors that may have had a lengthy period of gestation or product/market development but which now need to access equity to fully launch. This includes, for example, companies in the creative industries, including fashion and design, and manufacturing companies, many of which are based in the UK's regions. There remains continued vagueness about what is test marketing, or entering new markets.

We also think that the growth and development test for companies over seven years old that are seeking investment to fund either the development of new products or the entry into new markets (or both) needs clarification and is open to subjective evaluation by HMRC. Providing firms with certainty on the application of the seven-year rule would encourage additional investment into firms entering new markets, and firms developing new products or products with particularly long development phases. It would also reduce the burden on the advance assurance service, and the length of time it takes companies to receive investment.

We recognise that Knowledge Intensive Businesses are able to have more flexible rules about the amount of money that they can raise, and the age and size of the company as set in the State Aid provision. However, we feel that the criteria for what constitutes a Knowledge Intensive Business needs reviewing and the UK should adopt a more flexible approach to ensure that companies are not just those in formal research and development or academic institutions. For example the ruling about having a very high percentage of staff with PhDs does not reflect the staffing of high-growth-potential digital technology companies focusing on very innovative new technologies or products where a much wider base of skills would be needed. We feel that the KIB criteria should be simplified and loosened so that companies with real potential to scale and grow can take on high levels of finance annually and over time; and this would leverage further private sector investors using the EIS scheme in this area to back these highly innovative businesses through their longer period of development, allowing investors to deploy further capital into these companies.

Q10: When is it more appropriate for government to support patient capital through investment rather than through a tax relief?

We do not believe that this is a binary choice. UKBAA firmly believes that the existence of tax relief under EIS and SEIS is fundamental to ensuring the flow of private investment into early-stage businesses; and that this ensures there is a supply of patient capital for early-stage companies to access when they are in such early-stages of growth that they are too risky to attract alternative finance sources. However, there could be a role for Government to support patient capital through funds designed to co-invest with or follow-on from angel capital; and not displace this valuable source of investment from private individuals acting as business angels.

Co-investment Funds have been shown to significantly leverage and stimulate private sector investment with ratios between x3 - x6 leverage of private capital, demonstrated by the Scottish Co-Investment Fund, Angel CoFund and the London Co-Investment Fund.

There is an important need to ensure that government investment in patient capital is going to crowd in other private sector capital and not displace it; and this should complement the tax relief schemes.

Q11: 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?

It is difficult to lay down an optimum minimum time period for investment since many factors can affect this.

The implication that many investors encourage early exit may reflect the conventional holding period for VC funds, which is 5-8 years, and they may push their portfolio companies to achieve exits in this period. Most VC funds (as opposed to VCTs) are limited life LPs with ten-year lives. This term is too short and constrains the ability to run the portfolio winners for long enough; and leads to pressure on having to make exits too early and not scaling to unicorn size. An evergreen structure (with a mechanism for liquidity to ensure investors can exit) is a much preferable structure.

Typically, angel investors can take up to 10-12 years before they achieve an exit and this has become an accepted expectation by angels, reflecting also American angelss experience. [15] Angels are aligned with the businesses they back and do not force exit but will support the business to focus on growth and achieving scale, and will support them in the identification of an appropriate exit. Exits can often take a long time to achieve.

However, we also acknowledge that, for many angels, considerations about options for exits can be restricted to trade sales, whilst for a number of angel-backed businesses the pathway to AIM and a public listing can be better option. We feel that many angels lack the knowledge and support to consider this option and we are working with AIM and the London Stock Exchange to increase the knowledge and understanding of angel investors and the companies that they back about the opportunities offered by IPO and the AIM market. We are also supportive of the ELITE programme operated by LSE together with Imperial Business School in establishing the knowledge and skills among growth-focused entrepreneurs to understand their growth and investment options.

It is also important to note that exits are not always bad for the economy, since we know that many exited entrepreneurs become active business angels supporting the next generation of high-growth

[15] Tracking Angel Returns; Robert E Wiltbank, Angel Resource Institute 2016

entrepreneurs with both cash and experience; whilst may go on to start up other new high-growth companies. Key examples are the Innocent drinks founders who went on to found JamJar Investments; Passion Capital, set up by founder of exFM; and Founders Factory and Made.com, set up by co-founder of Last Minute.com.

This reinforces the importance of maintaining Entrepreneurs' Relief to enable founders to reduce their CGT considerably on the sale of their business and thus have capital to reinvest in the next generation of entrepreneurs.

Q12: 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?

We remain concerned about the restrictions and delays in high-growth-potential businesses achieving advanced assurance for EIS/SEIS eligibility and we believe that the lengthy delays need to be addressed to avoid entrepreneurs failing to access the angel investment they need, which can result in total business failure or failure to grow. It also creates uncertainty around whether investors will continue to invest if the process becomes too complex, resulting in businesses failing to access the investment they need.

It is important to support capacity building and awareness programmes to ensure that private investors are aware of tax reliefs and to create a more level playing field for EIS/SEIS take-up in regions across the UK where the level of private sector investment to support early-stage risk businesses is severely lacking. The UKBAA e-learning programme is designed to increase understanding about how to make effective investment decisions and how the tax relief schemes can be used to support risk taking so that tax breaks can be focused on investments in businesses with high-growth potential – and so that the power of tax breaks plus knowledge capital can be effectively mobilised.

Q14: Should resources be focused on one intervention (e.g. a single fund of significant scale) or spread over a number of different programmes?

On balance, rather than spreading intervention across a number of measures, it would make greatest difference to have a single major intervention where a sizeable investment can be made to leverage the greatest amount of funds into the sector.

In terms of scale, this is difficult to assess but should at least match the EIF's investment in UK equity finance. It is also important that the Government seeks to avoid the risk that the EIF simply withdraws from the UK market before 2019. The Government should therefore seek to launch the new National Investment Fund as quickly as possible.

Q15: 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?

We would recommend that the Government seeks to ensure that the scale of funding provided by the EIF should continue; and we understand this is around £400-500m per annum. The timescale will depend on what implementation period/transitional arrangement we have with the EU and the type of future relationship we have with the EIF.

In replacing the EIF, it will be vital to ensure that the model is not based on displacing existing investment and that it encourages private investors into the venture capital market. Thus it needs to establish a mechanism that generates strong returns. The consultation document's research appears to show that direct investment (where government earns a return, as in the ECF and Angel CoFund programme) should be the preferred structure.

We feel the emphasis should be on the venture sector rather than PE, which does not appear to suffer from the same market failure.

Q16: Beyond replicating existing EIF investment if required, what areas should government focus on to increase investment in patient capital?

We recommend that further encouragement be given, including relevant tax incentives, to enable UK-based corporates to further develop venture capital funds that support innovation and market access for small innovating businesses and enable ongoing growth and scale-up. There is clear appetite being shown by corporates across a wide range of sectors to engage with innovative UK entrepreneurs in accelerator programmes and investment events, so the timing could be right to further attract corporate patient capital.

We also feel that Family Offices are an untapped resource, with many now focusing on tech investing through a younger generation that understand the technologies. Consideration should be given to both awareness raising and the potential to give tax incentives to encourage them to bring their capital to UK-based high-growth-hocused businesses.

Q20: Will focusing resources on increasing investment provide better value for money than changes to the tax environment?

As has already been identified, the EIS tax relief scheme needs to be maintained at the current level to ensure that there is continuing supply of private sector finance and especially smart capital into high-growth-potential businesses.

We also recognise there are some areas that can be tightened or improved to address concerns about tax advantaged planning and to ensure that we have a group of discerning investors using the scheme and bringing real added value.

However, the EIS tax reliefs need to work alongside a well-functioning supply chain of growth finance. Angel investors need to have assurance that the businesses they have backed through several rounds of investment at the start-up end can go on to access the long-term capital they need to support their growth, through the often very lengthy journey from start-up through to successful scale-up.

We need to have much more significantly sized funds to take companies through multiple scale-up rounds; and we believe there is a vital role for Government, working also through the British Business Bank, to establish a new fund and to attract institutional investors (including UK pension funds as well as wider international investment funds) into the UK to build a long-term funding base. There is an urgent priority to create a connected supply of long-term risk capital that enables businesses to access the patient capital they need to build their global growth here in the UK.

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