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PATIENCE IS A VIRTUE – GOVERNMENT'S PROPOSALS ON UNLOCKING CAPITAL FOR INNOVATIVE UK BUSINESSES

The UK Government announced in its 2017 Budget that it would be pursuing a new action plan to help finance innovative UK firms. The proposals follow a year-long Government review process launched in November 2016 after Prime Minister Theresa May's address to the Confederation of British Industry on her vision for UK business. The Patient Capital Review focused on how to address the funding gap for UK scale-up businesses. This briefing sets out the key recommendations from the review's panel of industry experts and the main Government measures announced in the Budget on 22 November 2017.

Key issues

- The 2017 Budget announced several new measures aiming to boost access to finance for UK scale-up businesses
- The measures include £2.5bn public money invested in a new patient capital investment fund within the British Business Bank
- A panel of industry experts provided recommendations to the Government, several of which were adopted

The Patient Capital Review

The Patient Capital Review was a Government review process announced in November 2016 that aimed to strengthen the UK's position as a location for innovative firms to obtain the long-term 'patient' finance needed to scale up their businesses. The review process incorporated a public consultation phase which ran from August to November 2017.

A panel of industry experts, composed of investment professionals, academics and entrepreneurs, was convened by the Government to support the Patient Capital Review, shape the themes of the consultation and provide recommendations to HM Treasury. The panel was chaired by Sir Damon Buffini and submitted its recommendations to HM Treasury in October 2017. Clifford Chance worked as part of the team of expert advisers supporting the panel with particular focus on relevant legal, regulatory and tax aspects of the potential reforms considered by the Patient Capital Review and the ultimate proposals. The secretariat team was composed of Clifford Chance, EY, L.E.K., McKinsey and The Wellcome Trust.

The Patient Capital gap

In her speech to the CBI, the Prime Minister noted that "while the UK ranks 3rd in the OECD for the number of start-ups we create, we are only 13th for the number that go on to become scale-up businesses". Evidence set out in the Government's consultation paper suggests that the UK has fallen behind its potential in scaling up successful UK start-ups, particularly when compared to the United States. A key identified factor in this failure to scale up, and the basis of the Government's consultation, is the idea that a lack of long-term

What is 'Patient Capital'?

The Government consultation paper defines patient capital as:

"long-term investment in innovative firms led by ambitious entrepreneurs who want to build large-scale businesses"

financing in the UK for small, innovative firms is holding back ambitious entrepreneurs from successfully commercialising their innovations. Whilst the UK is recognised as having world-leading universities and a vibrant start-up culture, the Government consultation paper sets out that ineffective deployment of capital within the market and barriers to investment in illiquid assets have contributed to a gap in the supply and use of patient capital which inhibits innovative UK firms from reaching their potential. The panel of industry experts estimated that there is demand for £3-6bn in additional funding annually from the UK's best high-growth businesses.

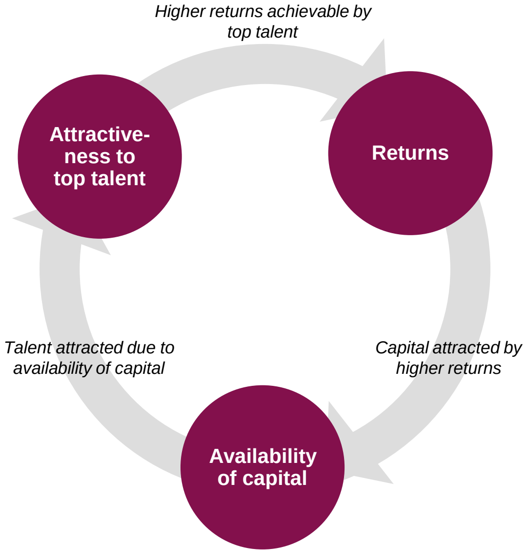

Image: 'The Patient Capital Feedback loop' from the Industry Panel response paper.

A new Patient Capital Investment Fund

The panel of industry experts recommended that the establishment of a new Patient Capital Investment Vehicle which would allow "the aggregation and deployment of capital at scale" for UK scale-up businesses. Whilst the recommended vehicle would be independent of Government, it would have a Government-defined mandate and it was recommended that Government should act as a cornerstone investor to "signal strategic intent and stability". It was recommended that the fund could be structured to allow investment from retail investors alongside institutional capital.

The Government has announced that it will set up a new fund incubated within the British Business Bank (BBB), a government-owned, independently managed development bank. This fund will be seeded with £2.5bn of public money which should, according to the Government, allow £7.5bn of investment to be unlocked through co-investment with the private sector. The aim will be to float or sell the fund once it has established a sufficient track record (in accordance with State aid rules).

The Government also announced that it will invest in a series of private sector fund of funds. Up to three waves of investment will be made which the Government expects to catalyse the formation of up to three fund of funds. The first wave of investment will be up to £500mn from the BBB and the Government expects the ratio of public to private capital in the first wave of funding to be 1:2.

An SBIC-style programme for the UK

The Panel recommended that a new programme modelled on the US Small Business Investment Company (SBIC) programme be introduced in the UK. The programme would be targeted at venture investment funds qualifying as a Patient Capital Investment Company (PCIC) e.g. funds investing long-term in UK based scale-ups and science-based start-ups. The PCIC qualification and licensing process would be overseen by the BBB. PCICs would, in addition to raising capital from private investors, be able to raise capital through funds borrowed from UK commercial lenders with a BBB guarantee. Any funds raised via the BBB-guaranteed debenture would be capped relative to the amount raised through private investment and PCICs would have to pay a fee to the BBB. The panel sets out in their response that capital raised through the BBB-guaranteed debenture would "create a leverage effect on private capital which boosts returns on equity".

The Government responded that the Panel's proposal should be studied in detail and announced that HM Treasury and the BBB would carry out a feasibility study to implement an SBIC programme in the UK through a new guarantee programme.

Overcoming barriers to investment in illiquid assets

The consultation posed questions on how to support investment into innovative firms by institutional and other investors who typically face regulatory barriers to investing in illiquid assets such as patient capital. The panel recommendations included measures to encourage retail investment, notably proposing an "opt-in" arrangement for new payments into defined contribution pension schemes to allow members the option to allocate a small proportion of their pension to patient capital investments. The panel also suggested that the Government consider incentives for retail investors investing in the panel's proposed patient capital fund including removing the taper allowance for high earners and adjusting the lifetime pensions allowance (subject to EU State aid rules).

The Government's response was that it will establish a working group of institutional investors and fund managers to "unlock further supply of patient capital" which will include work to tackle barriers to investment by defined contribution pension savers in illiquid assets as highlighted in the panel's recommendations. The Government also confirmed that the Pensions Regulator will clarify guidance on the ability of trustees to invest in venture capital and other illiquid assets to "give pensions funds confidence that they can invest in assets supporting innovative firms as part of a diverse portfolio".

Shifting tax incentives

Tax-advantaged venture capital schemes such as the Enterprise Investment Scheme (EIS) and the Venture Capital Trust (VCT) scheme aim to attract funding to UK start-ups by offering tax relief to investors.

The industry experts panel recommended that the existing EIS and VCT schemes should be enlarged to "enable Angels and VCTs to provide follow-on funding to scale-up businesses" including through the removal or expansion of current investment caps on the EIS and VCT schemes.

The Government has proposed that from April 2018 the annual limit on the amount individual investors can invest into knowledge-intensive companies (KICs) and the annual limit on the amount of investment KICs can receive through EIS and VCT schemes will be increased (see box on the right). As the current limit on the amount of annual EIS/VCT investments KICs can receive is defined by a European Commission State aid clearance decision, the UK Government will need to apply to the European Commission for approval of the proposed extension in line with EU State aid rules.

The Government has also announced added flexibility to the current EIS and VCT age limit for KICs. Currently KICs must raise their first investment under EIS and VCT within 10 years of making their first commercial sale (the age limit is 7 years for non-KICs). From April 2018 KICs can choose whether the 10 year period starts to run from the date of the company's first commercial sale or the point at which the company's turnover reached £200,000, allowing KICs who make a commercial sale but remain below the £200,000 turnover threshold for a period of time to benefit from these schemes for longer. This change will also require State aid clearance by the European Commission.

However, the 2017 Budget also imposed some restrictions on current venture capital schemes. The Government announced a new "principles-based test" which would aim to exclude relief under the Seed Enterprise Investment Scheme, EIS and VCT schemes for investments which are structured to provide a low-risk return to investors. The new test is aimed at ensuring the schemes "are focused on companies with high-growth potential" and will apply from the date of the Royal Assent of the Finance Bill 2017-2018. The Government also announced changes to the current VCT rules in order to aim to target VCTs towards investment in higher risk areas of the market and also to remove some current restrictions considered unnecessary.

The Government has also announced that it will consult on the technical detail of proposed anti-dilution measures for Entrepreneur's Relief to address concerns from some respondents that the current 5% minimum shareholding requirement could discourage investment when founders' ownership stakes are diluted by multiple investment rounds.

The Brexit question

The Government's consultation paper and response was largely quiet on the question of the UK's upcoming withdrawal from the EU. As the UK-EU Brexit negotiations continue, it is as yet unclear how the start-up industry and wider investment community will be shaped by Brexit in the years to come. Concerns remain over a number of issues including the potential loss of entrepreneurial and research talent and the post-Brexit role of the European Investment Bank (EIB) and European Investment Fund (EIF).

The EIB and EIF currently provide billions of pounds of funding to the UK each year including, as the panel noted, almost £400mn annually from the EIF for UK scale-up businesses. The Government noted in its consultation response that some respondents to the consultation had proposed that the Government set out plans to replace the EIF. However, given the ongoing Brexit negotiations the Government responded 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 European Union. Allocation of resources across programmes would be reconfigured if the UK does not retain a mutually beneficial relationship with the European Investment Fund."

While the Government's announcements in Westminster on its new action plan form part of its vision for a post-Brexit economy that is "fit for the future", it is nevertheless the case that much of the future landscape for UK investors and entrepreneurs will likely be shaped by agreements made in Brussels.

Venture capital scheme investment limits

Proposed limits would take effect in April 2018:

- Annual investment limit for EIS investors

  Current: **£1 million**

  Proposed: **£2 million** if any amount over £1 million is invested in KICs

- Annual investment limit for KICs through EIS and VCTs

  Current: **£5 million**

  Proposed: **£10 million** (remains £5 million for non-KICs)

- Lifetime investment limit for KICs through EIS and VCTs

  Current: **£20 million** (£12 million for non-KICs)

  Proposed: **unchanged**

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