



**Bridging the Finance Gap: A Consultation on Improving Access to Growth
Capital for Small Businesses**

**Consultation Response: HM Treasury and Small Business Service
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NESTA
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NESTA – the National Endowment for Science, Technology and the Arts - was established by the National Lottery Act in 1998, as the UK's first National Endowment. The Act tasked us with:

- Helping talented individuals – or groups of individuals – in the fields of science, technology and the arts to achieve their potential;
- Helping people turn inventions or ideas in the fields of science, technology and the arts into products or services – which can be effectively exploited and the rights to which can be adequately protected;
- Contributing to public knowledge and appreciation of science, technology and the arts.

NESTA's work is delivered through our three core programmes – Invention and Innovation, Fellowships and Education. These set out to do the following:

Invention and Innovation – to help talented individuals, micro-businesses and small teams to develop and protect their original ideas into products, services, or techniques with commercial, cultural and social potential;

Fellowship – to provide exceptional people with the time, space and resources to pursue their creative goals, explore, experiment, break new ground and develop their talent;

Learning – to support inventive ideas in teaching and learning, aiming to foster creative ability and public appreciation of, science, technology and the arts;

In responding to this consultation, NESTA is not attempting to discuss all of the issues raised. Rather, we are restricting our response to those areas where NESTA's experience as one of the UK's largest sources of seed capital (through our Invention and Innovation Programme) has given us an insight.

Premise of the Consultation

NESTA agrees entirely that there is an increasingly important role for SMEs to play in raising the UK's productivity, meaning that it is in the interests of the economy as a whole to ensure that they are able to access efficiently the capital they need if they are to achieve their potential. We therefore fully back the Government in trying to create a supportive business environment for SMEs and to address market failures. We believe that the issues identified in this consultation are particularly acute for the enterprises with which NESTA is involved: high-innovation and high-risk start-ups in Science, Technology and the Arts. These are, in many cases, enterprises where a relatively small investment can potentially reap large returns. NESTA is addressing these issues through our own support for people and projects. However, as a small organisation with limited resources and a wide remit, there is a limit to what we can do. We therefore welcome a greater emphasis on these enterprises in the development of policy.

However, we believe that the desired objectives for this policy will not be fully achieved simply by implementing the proposals in this paper. There is an equally acute need to address demand-side issues, as well as working to increase the supply of equity funding for the SME sector. Again, this is particularly the case for those working in high-tech start-ups. In NESTA's experience, a lack of management and financial skills among the businesses we support is among the largest barriers to accessing the necessary finance. As a result a large proportion of NESTA's support is non-financial, helping the projects we support through mentoring and advice. While the need to improve these areas are generally acknowledged in the consultation paper, there is no indication that any further

initiatives in this area are forthcoming. We feel that any policy which does not address these issues as a priority will not be as successful as it might be in increasing the level of equity investment in these businesses.

Issues Facing High-tech Enterprises

As set out above there are a number of issues which affect start-up enterprises, particularly in the high-risk, high-tech sectors with which NESTA is involved. Whilst access to finance is a very real problem, we feel that the paper does not sufficiently recognise the problems which are not directly related to the availability of funding. We highlight below three which should be central to further policy development.

The hidden (but very real) cost of the huge time involved in fund-raising. For a technology-based company, the market window is probably limited since competing technologies are being developed all the time. Their own technology therefore needs rapid development with as few interruptions as possible. However, the fund-raising process takes a minimum of 6 months and usually closer to 9-12, always involving large amounts of senior management time. This detracts enormously from technical and commercial development in companies that cannot afford the additional management. In the current funding environment, this means most companies. This creates a vicious circle: if the company cannot demonstrate technical progress and misses milestones, especially during the 6 months or more that the fund-raising process will take, the likelihood of their raising funds is reduced.

This is compounded by the structure of the Venture Capital (VC) industry which means that, in the UK, an early stage technology company is likely to have to go to many different financiers when moving through its life cycle, and each of them will mean both an education process and a culture change.

Management. Early stage companies have two options to aid their development: do things yourself and hope you don't commit any fatal errors during the learning process, or buy in the skills. The latter is expensive, since a good full-time Commercial Director will cost at least £60K plus on-costs. Therefore most early stage companies shy away from hiring in skills until they have funding. But the vicious circle appears again, with the financiers wanting to see the skills on board before they will invest¹, and the impact that they should have is all in the future projections rather than the past achievements for the investors to look at.

Market and procurement. There is a growing call for government to make procurement from small businesses a priority, particularly high-tech companies, and we would like to add our voice to this. The US sets aside a percentage of government contracts for targeted procurement and there is no apparent reason (State Aid aside) why the EU could not do the same.

Assessing the Finance Gap (Chapter 2)

NESTA agrees that there is a continuing and growing investment gap facing SMEs in the UK. From our experience we would, however, estimate that the lower end of this gap is substantially below the £250k quoted in this consultation. We

¹ This can be addressed in some cases by lining people up to come on board subject to finance. However, these agreements tend to fall down: for example, an MD will be in place subject to finance in March, but by September, when investors are ready to sign, has lost faith with the investors' endless questions and has accepted another offer.

believe that, for the enterprises we deal with, there is difficulty in attracting almost any finance beyond the “friends and family” round of maybe £20-£50K. In some sectors, the start of the finance gap may be even lower. NESTA’s support through our invention and innovation programme typically supports projects between £40k and £80k. However, as a result of the increasing difficulty our awardees find in accessing the next level of finance beyond this point, we are currently considering increasing the ceiling of our awards as a way of ensuring that the people we were established to help have the opportunity to continue to develop their businesses. At the upper end, we believe that the gap now extends beyond £1m, possibly as high as £2m.

Impact of Existing Interventions (Chapter 3).

NESTA would like to give its strong support to the encouragement of more formal business angel networks in the UK. The advantages referred to in 3.33 are all real and, in our experience, well understood by most angels, therefore requiring little “selling”.

A clear distinction should however be drawn between an angel group and a system of syndicated investment. Angel groups probably do not need a dramatic amount of encouragement, though perhaps a small (circa £10k) one-off grant to cover set up costs would be a welcome incentive

Syndication is altogether different, with the stronger networks having only got syndicates together in the last year or so and still struggling to make them work effectively. The learning from these experiences will need to be properly disseminated. There may be a role for Government in a one-off project to collect the experiences so far.

However, NESTA has concerns that the National Business Angel Network (NBAN) does not currently have the capacity to deliver initiatives of this sort due to its very early stage of development. We therefore believe that any initiatives aimed at encouraging more business angel syndication should be able to be accessed directly by existing angels from Government, rather than being managed through NBAN.

A key barrier to the development of groupings of Business Angels is the Financial Services and Markets Act (FSMA), which imposes considerable administrative burdens on groups of business angels currently wanting to formalise their relations. At present, the feedback that NESTA has received from Angels is that this piece of legislation acts as a disincentive to syndication. NESTA would propose that the Government undertakes to simplify the FSMA with the specific aim of removing barriers to angel syndicates, and producing template structures and documentation for doing so.

As stated above, NESTA believes that the equity funding gap is particularly acute for early stage, high-risk and high-innovation ventures. We therefore believe that any enhancements to the EIS and VCT schemes as described in paragraphs 3.28 – 3.31, should treat these sectors as a priority.

Small Business Investment Companies (SBICs) (Chapter 4)

General Observations.

As stated above, NESTA very much welcomes any intervention which will allow small enterprises (especially in the sectors which we were set up to support)

easier access to equity funding. We are therefore keen for the proposals set out to be a success, and fully support the principle behind them.

In making the case for the extension of SBICs from the US to the UK, NESTA feels that it is important not to under-estimate the differences between the equity funding markets in the two economies. Their differences are clearly illustrated by a number of comparisons in the consultation document. It is therefore also important not to assume that an intervention which acts as an incentive to investors in the US will automatically have the same effect in the UK. We are not yet convinced that, as set out in the consultation document, a US-style SBIC model would act as a sufficient incentive to outweigh the current reluctance among investors to become involved with SME equity finance. Again, this issue appears to be particularly relevant to the high-tech start-ups with which NESTA is primarily concerned. The proposed model still has the private investor bearing almost all the commercial risk, albeit with higher potential rewards available as a result of access to low-cost public leverage. The concept of sharing profits with Government may, depending on the proportions agreed, also act as a disincentive to investors becoming involved. NESTA's experience would suggest that investors are currently put off investing in small enterprises because of high levels of risk, rather than because the potential returns are not sufficient. As the consultation points out, the costs of attempting to mitigate this risk through increased due diligence work are prohibitive for sums under £1m. We are therefore concerned that this might continue to be the case even under a SBIC model, especially as Government is likely to demand at least as much protection against risk as currently exercised by private investors. If the development of a SBIC-style model is to be a success in the UK, it may be necessary in the future to give thought to altering the balance of commercial risk and profit-sharing between private investors and the Government. Any legislative or regulatory framework setting up a SBIC model should therefore contain enough flexibility to allow this to happen in the future if the model currently proposed does not serve as a sufficient incentive.

In addition, there is a risk that Government involvement in itself might act as a further disincentive for investors. The Government is, rightly, concerned with the need to protect public money against unnecessary risk. As a result, a regime is proposed that would largely protect public resources from loss. The associated monitoring and regulation may add to investors' costs, further dissuading them from becoming involved. The regulatory regime for SBICs should therefore be as light-touch, and low-cost, as possible to investors to avoid acting as a disincentive to market entry.

Finally, another potential barrier may be a lack of available finance for SBICs. NESTA understands that there was some difficulty attracting finance for RVCs from a wide range of investors, and that in the end only a relatively small number became involved. SBICs would be aiming to attract substantially the same investors as RVCs, so it is important that Government is sure that the money will be there to finance them. The Consultation seems to suggest that Government believes that significant additional investment can be attracted primarily from groups of individuals such as syndicates of business angels or similar organised groupings. This may potentially cause a problem. As set out above, the development of these groups is at a very early stage. As the consultation points out, angels are not yet in the habit of forming syndicates. In addition, regulatory and legislative barriers currently act as a disincentive to syndication. As a result, we feel that an over-reliance on this sector as a source of funding for SBICs may lead to difficulties in attracting sufficient finance to make SBICs viable.

Specific Comments

SBIC Objectives (4.5-4.16)

NESTA would welcome an additional objective for the SBICS to encourage investment in innovation. High-innovation enterprises are those which often have the highest potential returns on investment, but are often currently those which find equity finance most difficult to come by.

We are also concerned that the laudable desire for this initiative to become self-financing over the medium term should not lead to a tendency to invest in “safer” sectors at the expense of riskier, but potentially more rewarding, projects.

Sources of Fund Managers (4.10 – 4.12)

NESTA has been involved, from within the public sector, in the negotiation of deals with innovative and risky small businesses since we started operations in 1999. As these proposals develop, we would be very interested in playing an active role in discussions, and feel that we have a unique perspective – as a public sector body already involved in these sorts of investments – which would be valuable to colleagues in central Government. We are also open to the idea, in time, of acting as a partner in a SBIC, depending on the nature of the legislative and regulatory framework.

We would argue for the inclusion of the existing RVCF and UCSF managers as potential managers for SBIC funds. New initiatives should not work on the assumption that management will always graduate from small companies to large investments. People with specific early stage skills should be persuaded to stay where they are so that the sector is properly served. It should not be seen as a training course for “real” VC. In fact, the opposite is more likely to be true, as early stage investments are far more difficult.

NESTA would argue that the most practical way to manage investments in this area is to encourage the creation of integrated fund management groups that manage funds covering ALL stages of investment from Proof of Concept through to pre-IPO. This would allow investors to take an idea all the way through without enterprises having to seek a new lead investor at several stages along the way.

Sizes of viable funds. (4.20).

NESTA agrees that a balance needs to be struck between making sure a fund is of a viable size, while also ensuring that the minimum fund size does not become a barrier to entry. We also agree that it would be reasonable for Government to impose a minimum fund size as a pre-requisite for access to Government lending. NESTA would agree that, for an average investment of £650k (around the mid-point of the identified funding gap), a minimum size of fund would be at least £10m. Any less could mean unacceptably high risk as a result of insufficient diversification.

Model Contracts 4.29.

NESTA strongly supports the development of model contracts. However, this will only maximise effectiveness if it takes place alongside a programme of education for investees.

Appetite among private investors for a leveraged investment scheme where the private investors take first loss (Qu 4.16)

NESTA is concerned that this may only be attractive to existing business angels who, as discussed above, need further support in working within syndication structures before SBIC's will work properly.

Licensing Authority (4.57 – 4.61)

It is acknowledged that the pool of potential SBIC fund managers is already not currently sufficiently deep. However, in order to work effectively, any licensing authority will need to employ people with the skills and experience similar to those needed by SBIC fund managers. Care will therefore need to be taken to ensure that this pool is not further reduced by a large number of potential fund managers working instead for a regulator.