RESPONSE TO HM TREASURY CONSULTATION

FINANCING GROWTH IN INNOVATIVE FIRMS

LINC SCOTLAND

1. Introduction and Background

1.1 LINC Scotland

LINC Scotland is the national association for business angels in Scotland, with a membership which includes many active individual investors and most of the main angel groups or syndicates. It provides funding and educational support for developing and established business angel groups in Scotland and is itself a non-profit enterprise promotion body funded by its members and corporate sponsors as well as public partners such as ERDF and Scottish Enterprise.

LINC Scotland represents its members at government level in Edinburgh, London and Brussels and was a founding member of the European Business Angels Association (EBAN), Business Angels Europe (BAE) and the World Business Angels Association (WBAA).

Since 1993, LINC Scotland has played a significant and active part in changing the business culture in Scotland and the Scottish business angel marketplace is now recognised as amongst the most developed in Europe by the likes of the OECD[1]. In the 2016/17 tax year the Angel members of LINC invested £23.25 million of their own capital, and leveraged a further £12.13m of private and £13.57m of public funding into 67 companies.

What has become known own as the "Scottish Model" has been adopted by the Republic of Ireland, Northern Ireland and most recently in Wales in the design of the forthcoming Development Bank for Wales. Wider afield, over the last 12 months, LINC has been consulted by the likes of the World Bank, the Inter-America Development Bank and the German Development Corporation GIZ and the European Commission to assist in the development of the funding for high growth potential companies in Europe, South America, North Africa and the Caribbean. We believe that some of the experience and lessons learned in Scotland may be useful in helping to develop further national UK policy.

1.2 Business Angel Activity in Scotland and the UK

The importance of business angels in supporting the development of a dynamic entrepreneurial economy has been recognised by both national and regional governments in in the UK and beyond.

Investment provided by business angel investors is one of the key sources of entrepreneurial finance in Scotland. Since its inception as an asset class in the early 1990s, business angel investment in Scotland has moved from being a fragmented and largely invisible market comprising almost entirely individuals investing on their own or in ad hoc small groups to one that is increasingly characterised by highly visible angel groups and syndicates which consolidate and channel finance from individual investors to entrepreneurial ventures.

Business angels are particularly important from a regional economic development perspective because the majority of their investments are local, hence they are typically recycling and reinvesting locally-created wealth.

Given the concentration of venture capital investing in London and the South East, business angels are particularly important in areas such as Scotland. It is important, therefore, that one

[1] Financing High-Growth Firms The Role Of Angel Investors, OECD, 2011, page 90.

outcome of the current consultation is that business angels remain incentivised to continue investing in the UK regions through continuation of targeted tax breaks.

An important adjunct to business angel investment activities in Scotland is the leverage which is provided by the Scottish Investment Bank, though the Scottish Venture Fund, a discretionary co-investment fund, and particularly the Scottish Co-Investment Fund, which provides a pool of co-investment capital to accredited private sector investment partners who have met specific criteria set by Scottish Enterprise in relation to track record and investment processes.

This "Scottish Model" of public/private partnership has been replicated in many parts of the world and has led to a thriving environment for innovative companies to access funding and support for their activities.

1.3 The Development of Business Angel Syndicates in Scotland

In Scotland, the Business Angel model has largely moved away from individual investors or networks, to the emergence of professional, organised Angel syndicates.

The majority of these syndicates, in partnership with the Scottish Investment Bank, will typically provide up to the first £2m of start-up and early stage capital to companies in Scotland, before seeking to pass the investment baton to new investors to provide later start-up capital and Series A funding.

However, a number of larger syndicates have emerged, most notably Archangels and Par Equity, which are prepared to provide larger investments over a longer period of time. These groups will typically manage between £10-20m of investment into their portfolio of companies each year. It is notable that the majority of this is dedicated to follow on funding, demonstrating a commitment to support the long term growth of the companies. These investment syndicates operate with dedicated investment teams and investment processes which are similar to those of venture capital investors.

There are a number of reasons for the emergence of these larger syndicates. Firstly, business angels often have difficulty investing alongside venture capital funds because of the investment instruments which VCs use, notably, liquidation preferences, anti-dilution rights, special subscription rights and enhanced follow-on rights. These often have the effect of prejudicing early investors, particularly where there are significant follow-on funding rounds. While the angels provide the earliest, and riskier funding, the preferential returns required by VC funds often significantly reduce, or even eliminate the angels' share of any profitable exit returns.

Secondly, business angels and venture capital funds typically have different objectives. Venture Capital fund managers are focused on providing a financial return to their fund investors within a defined period sufficient to allow them to raise subsequent funds. Their motivation is therfore to maximise the overall fund return rather than maximise the optimal value of each individual company. Their primary source of income is that of management fees, derived from the process of investment rather than from exit value. Business angels tend to be motivated to a significant extent by the idea of "giving something back", actively wanting to support the next generation of entrepreneurs. As a result they are often prepared to be more patient before seeing a financial return. They earn their return as a result of value creation within the investment company, in other words entirely outcome based, not through fees generated during the investment process.

These differences have reduced the appetite of angels to invest alongside or seek follow on investment from VCs both in the UK and the USA[2].

Given the length of time it can take for innovative companies, in particular, to reach commercial viability as independent entities, VCs are often either unwilling to invest or will structure their investments in such a way as to unacceptably dilute the returns of early investors. This has led to angel syndicates such as Archangels becoming more organised to make more follow-on investments, taking businesses to exit themselves.

1.4 Case Studies

Archangels, which is the largest professional business angel syndicate in Scotland, and which has been operational since 1992, has the most developed track record of all of the professional syndicates in Scotland. A recent report by the Hunter Centre for Entrepreneurship at the University of Strathclyde, estimated that the Archangels' investment portfolio had created over 3,500 highly skilled jobs and had contributed an economic value add of around £9 for each £1 invested by Archangels. In addition, each £1 of investment by Archangels was estimated to have generated around £14 of turnover in its portfolio companies.

To date, Archangels has achieved 21 profitable exits, of which 16 were by way of trade sale. On average, it took just over eight years from Archangels' initial investment (usually at start-up) to exit, with an average of £3.5m of invested capital.

However, to develop some of the larger companies in its portfolio took significantly more funding. Touch Bionics, for example, which employed around 125 people at the point it was sold to Ossur in 2016, consumed £12.9m of investment capital over 13 years. Archangels remained lead investor during this period, funding the company from a spin out from Scottish Health Innovations, the commercialisation arm of the Scottish National Health Service, to an independent, profitable company of some scale.

Three of the Archangels portfolio companies also participated in Initial Public Offerings. On average, these companies required just over £20m of capital to get to that point. Optos, for example, received initial proof of concept funding of £80k from Archangels in 1992. Archangels led a further £38.5m of funding over a number of investment rounds into the company before its IPO in 2006. Optos was sold to Nikon in 2015 for £259m, but it continues to employ some 400 people world-wide, of which 200 are based in its main r&d facility in Dunfermline, Scotland.

The conclusions from the Archangels' track record are therefore as follows:

- It can take **up to ten years** (and often longer) for an innovative, high growth potential company, to get from the point of first external investment to the point where it has made sufficient commercial traction either to be independently self-sustaining, or to be sufficiently commercially attractive to trade purchasers or purely commercial funders such as institutional and private equity funds.

[2] See http://www.early-exits.com/index.html

- It can take at least £3.5m of investment but often in excess of **£10m-£15m** for a company to be sufficiently commercially attractive to trade purchasers or purely commercial funders such as institutional and private equity funds.

A few further points should be noted:

- Archangels managed £118.2m of investment into its profitable exits, returning £297.3m of capital to investors.
- Just less than half of the investment and returns were attributable directly to Archangels' investors, with the balance from co-investment partners, the largest being funds managed by Scottish Investment Bank.
- The majority of Archangels' investment was by way of EIS qualifying investment into ordinary shares in the portfolio companies.
- Incentive to the Archangels' investors (EIS) and leverage to their activities (co-investment through SIB) allowed Archangels to be patient, supportive lead investors throughout the key formative years of some of Scotland's most innovative companies.

Response to Consultation

LINC Scotland has provided responses to those consultation questions which directly affect its member company interests. It is LINC Scotland's view that the questions to which it has provided a response should form the key focus of the Treasury's response in terms of policy intervention.

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

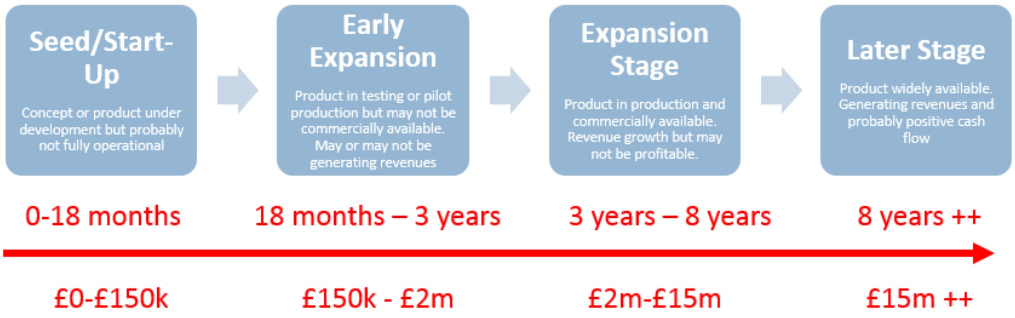
Yes, with the key funding gap at the £2 million to £10 million level. Innovative companies which have high growth potential typically undertake many years of research and development before their products can be brought to market. Whilst much of this can be funded through NRE (non-recurring engineering) projects with non-dilutive funding directly from end-customers, or through grant funding (SMART/Horizon 2020/Innovate UK), typically these sources will not be sufficient to fund all of the firm's growth or working capital requirements. At this stage of their development, innovative firms may be many years away from generating significant revenues. Investment in these companies is extremely high risk, with current research suggesting that even in very well developed markets such as the USA, 70% of invested companies fail to provide a return on investment[3].

Policy intervention, particularly through EIS, is therefore essential to incentivise patient, equity investment into these high risk, early stage, innovative companies. Our experience is that, as a result of the mix and consistency of policy interventions of the nature seen in Scotland, the availability of up to £2m of start-up/early stage capital for these companies has been good. The benefits of the EIS tax incentive have been leveraged by public sector support for the organisation of Angels into syndicates and the participation of the publicly-managed Scottish Investment Bank as a co-investment partner.. It has been the combination and co-ordination of these policies that has increased both capacity and capability of the private sector, ensuring not just an increase in the quantum of funding available, but ensuring it is delivered in the most effective manner. However, these companies have had more difficulty in accessing capital beyond the initial £2m. This has hampered the continued development of potentially high-growth companies and has led in some cases to the problem of "beached companies" where r&d has to be curtailed, companies failing to scale or indeed closing down.

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

In our experience, the table below sets out the most common funding journey for innovative, high growth potential firms.

[3] Tracking Angel Returns, Robert E Wiltbank, Wade T Brooks, Willamette University, Angel Resource Institute, 2016.



In Scotland, thanks to the co-ordination of policies to increase both the supply of capital and the effectiveness of its delivery, there is a well-developed ecosystem providing support and funding for seed/start-up companies and companies in early expansion phase. Good advice, mentoring, support and funding is available for innovative companies in their early years and availability of the first £2m of funding is generally good. This funding is generally provided by way of equity from high net worth individuals who obtain tax relief through SEIS or EIS at the point of investment. Such investment is leveraged by financial and other added value support from the Scottish Investment Bank.

Our experience suggests however that companies which are in expansion phase often struggle to obtain appropriate finance. This is particularly so for innovative, development led companies, which may take a long time to reach profitability. These companies do not meet the investment criteria for more conventional VC investors or growth capital investors such as Business Growth Fund, which require minimum levels of revenue or profitability.

As highlighted in section 1 above, our track record in Scotland suggests that innovative, high growth companies will require a minimum of £3-5m of equity investment to become viable and often in excess of £10m. In many instances, companies fail to access this capital either because of the inability of early investors to follow their money, or because of the unwillingness of commercial investors such as VCs and VCTs to provide funding where there are no significant revenues or profits.

It is our view, therefore, that there is a fundamental market failure which has resulted in innovative, high growth potential companies which have not reached profitability or significant revenues finding difficulty in sourcing scale-up capital. These companies will often have received up to £2m of investment from early investors and will be seeking a further £10-£15m to allow them to reach positive cash flow or to get to a position where established, commercially focused institutional and venture find investors are likely to be interested.

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

In our view, the EIS regime, in particular, is one of the most effective and cost-effective interventions the UK has made in encouraging patient capital investment. The intervention has been particularly successful in incentivising high net worth investors to invest their own money into innovative companies. These investors have typically had successful careers or are cashed out entrepreneurs and are motivated by giving something back and supporting the next generation of entrepreneurs with their time and money. They are generally more patient than investors who are constrained by conventional fund management considerations.

In our view, EIS has succeeded in incentivising targeted retail investment in growth orientated, innovative businesses.. Our view is that EIS has been a more successful intervention in this regard than SEIS. SEIS has tended to motivate purely financially (tax incentive) orientated investors and in our view, many of the companies supported through SEIS are less innovative and are less likely to scale. As the investors in these companies are motivated to a high extent by the tax incentives of SEIS they appear less willing to support follow on rounds of funding, curtailing a company's ability to scale. There is therefore a case for reviewing the efficacy of the SEIS regime to make it more focused on innovative, high growth potential companies, or indeed to remove the relief entirely and refocus policy intervention on the market failure which exists in funding for companies in the expansion phase.

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

In our view, the UK's main weakness in patient capital is the failure of early policy intervention to provide a joined up pathway of investment for innovative companies during the first ten years or so of their development, where, as r&d focused companies, they will often be unprofitable and therefore, in many cases, unattractive investment propositions to purely commercially focused investors, such as institutional investors and VC/PE fund investors.

A more joined up approach of policy intervention in this area of market failure should provide a larger, more attractive pipeline of investment opportunities for VC and other commercially focused investors. In our view, policy intervention should be focused on earlier stage investors during the first ten years or so of a company's development, rather than to later stage, more commercially focused investors. This would provide an improved deal flow for later stage VC investors, accelerate the time it takes companies to scale, and result in a higher level of success, improving the risk/return ratio of the sector and encouraging more new investors to consider this form of investment (both at early stage and follow on VC levels).

There are a number of barriers in place that discourage co-operation between the earliest funders on the funding ladder, particularly business Angels, and later stage funders such as VCs.

Measures that could be implemented to improve this situation could include adjustments to VCT rules such as:

- Removal of dividend relief to encourage investment in genuine technologically innovative companies that tend to be pre-revenue;
- Introduction of loss relief for underlying investors to encourage greater risk taking and investment in novel and innovative risky companies;
- Restriction of investment in companies by VCTs to ordinary shares to encourage greater co-investment and follow on investment with angel investors; and
- Allowing VCT investors to take out some/all early EIS investors, to facilitate market liquidity, freeing funds to re-invest at the earliest stage of innovative development, creating more potential scalable companies and encouraging more market entry by new funders as a result of demonstrating improved liquidity.

The second major weakness in the UK's approach to patient capital is in the lack of regional focus. To a large extent, access to capital for most innovative companies in London and the South East is relatively straightforward. However, it is less so in the regions. Retail, high net worth investors, who are the main supporters of early stage companies, generally prefer to be more regionally focused. Angel investors like to be engaged with the companies in which they invest. Most of the angel syndicates in Scotland have an investment focus in Scotland and therefore any policy interventions should look at how activities can be encouraged and leveraged more appropriately on a regional basis. Organisations like LINC Scotland and local co-investment funds can act as a catalyst for entrepreneurial activity within a region and should be supported.

A third weakness, seen particularly at a regional level, has been the tendency to structure local investment funds, for example as established under JEREMIE, in a manner that competes and crowds out the local private sector investors, particularly Business Angels. Regional funds of all sizes should by preference be structured as Co-Investment funds designed to “crowd in” the private sector[4]. Depending upon local regional circumstances the fund managers should be required to provide support and education to upskill the local private sector investors, as, for example, is required by the Northern Ireland Co-Fund[5].

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

Increasing the supply of capital to businesses will not in itself result in an improved level of funding if it is not accompanied by an increase in (informed) demand for such funding. There continues to be a need for structured investment readiness support to close the gap between the supply of capital and effective demand for investment.

While numerous enabling programmes exist, offering services in business planning, technical development, market analysis, financial forecasting, etc., few enabler managers or entrepreneurs have been through the fundraising process. As such, most programmes fail to prepare entrepreneurs for the capital raising process.

Entrepreneurs are left facing various challenges, including:

- Inability to identify an appropriate source of capital;
- Lack of understanding of common investment instruments;
- No understudying of, or preparation for, the investment process. What happens after a pitch?
- Misalignment of priorities between the investor and entrepreneur;
- Limited knowledge on due diligence requirements;
- Misalignment of structure and valuation; and
- No focus on the exit event for investors

The lack of knowledge and understanding of the investment process suppresses demand, and reduces the success rate of those that do apply for funding.

The lack of a company’s preparation and ability to effectively engage investors contributes to a perception of poor quality “deal flow” on the part of potential investors, limiting the supply of capital.

Effective deployment of capital is held back by a number of inefficiencies within delivery channels:

[4] See for example North East Access To Finance, Fund Evaluation Research, EKOS, June 2013, page 105.
[5] See Interim Evaluation of the Invest NI Co-Investment Fund (Co-if) Final Report, Deloitte, February 2014 “Investor Support and Due Diligence”, page 22.

SEIS / EIS funds: are significantly less effective in delivering long term "smart" capital to high growth potential companies than similar funds channelled through established angel investment groups. The funds are unable to adequately follow their initial funding over the many years it takes for companies to mature to a level of self-sufficiency or of being of interest to follow on funders such as VCs. The motivation of the fund managers (to earn fees from the investment process) is not compatible with the long term nature of early stage investing. The present FCA regulations should be adjusted to facilitate the establishment by angel groups of "**sidecar funds**", as increasingly seen in the USA[6], without the need for these groups to become fully FCA regulated. Investors in such funds would still benefit from the various tax incentives, however the funds would be more effectively directed to high growth business by experienced angel investors.

Asset Backed Companies: Tax relief under SEIS and EIS should be focused on investments made into high growth potential business, and represent an encouragement to invest in the most innovative, and likely the most risky investment opportunities. This is not likely to include "asset-backed" business, those business with significant value in tangible assets. In this regard we would include companies holding significant value in land and buildings, securities and other physical realisable assets. We would not include companies holding apparent value in intangible assets such as patents and other intellectual property, unless these were generating significant licence income. Many innovative companies hold intellectual property on their balance sheets that in practice is of no realisable value until significant further commercialisation work has been funded, work that typically takes many years and is inherently risky.

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

As identified in the Consultation (page 32) the principal deterrent to the supply of patient capital is the perceived poor risk/return ratio afforded by this asset class. "UK institutional investors compare these (VC returns) to returns made from other forms of investment with greater liquidity and lower dispersion in returns and, as noted earlier, are not willing to invest in the market in high numbers". This perception is not wrong.

For individual "angel" type investors the latest data from the USA suggests that as many as 70% of angel backed companies fail to return any capital to investors[7] with 85% of all returns coming from just 10% of investments made.

For VC funds as the Kauffman Foundation highlighted in its "We Have Met the Enemy… and He is Us" report, VC returns haven't significantly outperformed the public market since the late 1990s, and, since 1997, less cash has been returned to investors than has been invested in VC[8]. The top decile of funds performs well. The majority of the others not so well, with many losing money for their investors.

This issue can be addressed through education for early stage investors, and ensuring they are encouraged to invest in the most effective way, through organised angel groups.

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[6] https://www.angelcapitalassociation.org/data/ACANewsletter/2-11/Side%20Car%20Funds%20-%20An%20Introduction%20-%20Foley%20Hoag%202-11.pdf

[7] 2016 Angel Returns Study, Angel Resource Institute, 2016.

[8] "we have Seen The Enemy…And He Is Us", Kauffman Foundation, 2012.

Investors into VC funds could be assisted by improvements in the way fund performance is reported.

Actual performance can be improvedd by providing appropriate education and support to investors and companies to help them understand and prepare for the exit process more effectively. This would include support in relation to "exit readiness" and "corporate engagement".

Education should also highlight the "good news" relating to the UK in regard to successful exits. For example:

- Given the relative size of their economies, the UK has a very good record of IPOs in comparison to the USA. In 2016 there were just 106 IPOs in the USA. There were 67 IPOs in London.
- The UK is ranked 2nd only to the USA for the number of successful technology company exits in 2016[9].
- The UK leads countries in Europe in exit volume with 1,234 since 2010. It has exited more startups than Germany, France, Benelux, Spain and Italy combined in that period. The situation is similar for acquisition volume by country. The UK is at the top with 1,031 transactions, followed by France and Germany with 354 and 336 respectively[10].

Highlighting positive data will help to show that the UK is the preferred investment location.

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

In our experience EIS has been the most important intervention in supporting the investment of patient capital to innovative, high growth potential companies. In addition the allocation of co-investment funding through Scottish Investment Bank has effectively leveraged the supply of patient capital in the market, and encouraged the "professionalization" of angel investment by encouraging the development of formal syndication. As a result, the early stage investment ecosystem in Scotland has been very effective, particularly over the past 15 years or so. EIS has also allowed some investment groups, most notably Archangels, to invest much larger amounts, particularly where individual investors with deep pockets are managed by experienced investment professionals with a track record of patient, long-term investing.

Recent changes to EIS/VCT legislation have also led many VCT managers to focus more on patient, growth capital into innovative companies and additional changes to the rules around VCTs would be likely to improve that position further.

8. Are there areas where the cost effectiveness of current tax reliefs could be improved, for example reducing lower risk "capital preservation" investments in the venture capital schemes?

Whilst SEIS has introduced new investment into start-up companies in Scotland, we feel that the policy objectives in providing the intervention have not been achieved. SEIS has tended to motivate more purely financially orientated investors and in our view, many of the companies supported through SEIS are less innovative and are less likely to scale. There is definitely a

[9] "The 2016 Global Tech Exits Report", CB Insights,
[10] STARTUP M&As 2017 Report, Mind the Bridge & Crunchbase.

case for reviewing the efficacy of the SEIS regime to make it more focused on innovative, high growth potential companies, or indeed to remove the relief entirely and refocus policy intervention on the market failure which exists in the expansion phase.

We feel that carefully targeted changes to the VCT rules could have a significant impact in focusing retail investment towards providing pure growth capital to innovative companies which are seeking to expand beyond the early expansion phase towards commercial maturity. As such, VCT funds could become more closely aligned with EIS, providing a more joined up funding pathway for companies seeking to scale up. This could go a long way to dealing with the market failure we have identified, where innovative, pre-profit development companies, often struggle to raise £10-£15m of expansion capital beyond the initial £2m of invested capital.

We would suggest considering the following changes to the rules:

- Removal of dividend relief to encourage investment in genuine technologically innovative companies that tend to be pre-revenue;
- Introduction of loss relief for underlying investors to encourage greater risk taking and investment in novel and innovative risky companies;
- Restriction of investment in companies by VCTs to ordinary shares to encourage greater co-investment and follow on investment with angel investors; and
- Allowing VCT investors to take out some/all early EIS investors, to facilitate market liquidity, freeing funds to re-invest at the earliest stage of innovative development, creating more potentially scalable companies and encouraging more market entry by new funders as a result of demonstrating improved liquidity.

These changes would potentially build upon previous changes to the VCT regime, aligning the asset class more closely with EIS, therefore providing a more joined up pathway for innovative companies to achieve investment.

9. Are there other ways the venture capital schemes could support investment in patient capital, in the context of State Aid restrictions and evidence on cost effectiveness.

Government funds should be structured whenever possible as co-investment funds with the objective of crowding in the private sector.

The managers of these funds should be required to support the development of the skill base of the private sector, encouraging more private sector investors in particular to be capable of being “lead investors”. Page 24 the Consultation report notes that 78% of investment in the North East comes from “public funds”. It is likely that this is in part due to the structure and operation of the various public sector JEREMIE “VC” funds in effect crowding out the private sector, resulting in lower than might otherwise be expected angel investment in the region, and lower levels of engagement by VC funds from outside the region.

Regional funds should be seen as “feeder funds” for larger national and international VC funds: Evidence of this comes from the VICO Project, which highlighted the importance of linking high growth potential companies to VC funds with international experience[11]. It suggests that a regional venture fund may be too small, and have too short an

[11] “Venture Capital, Policy lessons from the VICO project” 2011(The VICO project, funded from the EU Seventh Framework Programme 1, studied the impact of venture capital (VC) financing on the innovation rate, employment creation, growth, and competitiveness of high-tech entrepreneurial

investment period (at five years or less), to fund a portfolio with the scale and diversity required to support companies through to a successful exit. Companies that only received funding from local investors developed less well than those that had achieved investment from outside the region. Fund managers should not be restricted to regional experience. In order for fund managers to achieve such follow-on investing, they must have the confidence of the potential follow-on investors. They must be seen as sources of quality deal flow. The procurement of future fund managers should emphasise that the applicant fund managers need to evidence significant previous experience of working with national and international fund managers to promote long-term company growth. Applicants should be asked to provide examples of companies that they have been able to "pass on" to next stage funders. The compensation package offered to fund managers should specifically encourage them to secure funding from larger follow-on VC funds. Fund managers should not be disincentivised from passing companies on up the funding escalator, for example through a fear of losing post investment management and monitoring fees.

Government backed venture funds should introduce a fund manager compensation scheme based on encouraging long term investment. This would be based on a budget-based management fee based on fund manager's operating expenses, and the replacement of the presently typical "carried interest"[12] calculated based on achieved exit values with a bonus based upon the achievement of follow on funding from new investors. A key objective of fund managers, particularly those appointed to a regional equity venture fund should be to prepare companies for future rounds of funding. Fund managers should be incentivised to do so. Fund managers would be encouraged to have greater interaction with likely follow-on funders. This would encourage the much-needed greater interaction between fund managers of different funds, recreating the funding escalator needed to assist the true high growth potential companies.

Venture Capital Schemes supported by government should have appropriate measures for assessment, based on the support for long term patient capital. Too often, particularly regional funds, have been measured against the quantity and speed of investments made, rather than the quality of investment. Appropriate measurements would include, as noted previously, the amounts of third party co-investment achieved, the amount of follow on funding achieved, and the increased value at which follow on funding is achieved.

Any solution e.g. a "national fund" must be delivered at a regional level.

Business angels and venture capital funds are influenced by the location of investors, investment opportunities and the friction of distance. All three factors favour areas that already have high levels of entrepreneurial activity.

The risk of having a single co-investment fund is that it would have an uneven impact across regions, favouring the most entrepreneurial regions.

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ventures in Europe and the role VC investors play in helping entrepreneurial firms bridge their resource and competence gaps).

[12] An Ernst and Young survey of Fund Investors found that 89 per cent of respondents want to see changes to the management fee - Ernst and Young, The Limited Partner VC Sentiment Survey, 2010. Metrick and Yasuda analysed ninety-four VC funds and estimated that VC funds receive nearly two thirds of their revenues from fixed fees rather than from the supposed performance-based carry - Andrew Metrick and Ayako Yasuda, The Economics of Private Equity Funds, 2010. http://www.stanford.edu/~piazzesi/Reading/MetrickYasuda2010.pdf.

This is what has occurred under the early operation of the UK government Angel Co-Fund with the investments concentrated in London, the Thames Valley and Cambridge, all areas with high levels of entrepreneurial activity. The Scottish Co-Investment Fund has also had the problem that its investments are skewed toward the east of the Central Belt (Edinburgh).

Influenced by these considerations, the Swedish approach has been to establish 11 regional co-investment funds[13].

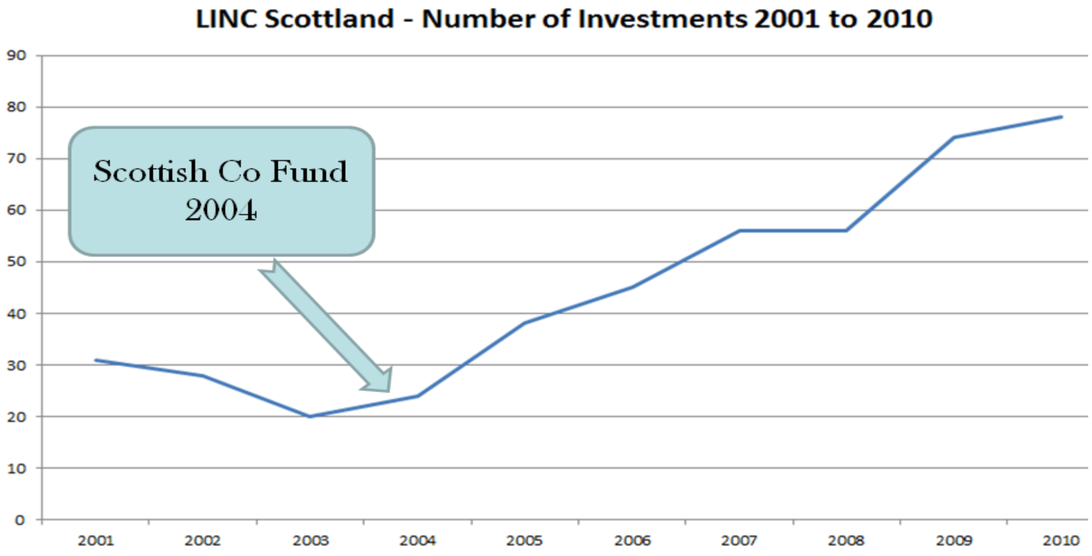
Each regional delivery Co-Investment fund (CIF) will need to have differing operating models and KPIs (especially re investment return) due to regional variations in investment conditions, including:

- Deal flow. There are likely to be fewer investment opportunities in rural, and less economically developed regions, compared with the city-regions. CIFs in these more peripheral regions will need to be more proactive in finding investee businesses. There will also be greater need for such CIFs to offer Investment Readiness programmes to growth oriented businesses. In less developed regions, the CIFs are more likely to be involved in the deal identification process. We can see the need for this when comparing the operation of the Scottish and Northern Ireland Co-Investment Funds.
- Investment Partners. There are likely to be fewer venture capital funds and business angels actively investing in less economically developed regions. CIFs in these regions may therefore have to partner with individuals with little or no investment experience (i.e. 'novice' and 'nascent' angels). – again, the position in NI.
- Type of potential investee company. The types of businesses looking to raise finance might be expected to vary across regions in terms of sector and stage. This might be expected to have an impact on the number and size of exits and fund returns.
- . Exits. We might expect that because of their characteristics (sector, innovation, stage) that investee businesses in less developed regions will encounter greater difficulties in achieving a profitable exit.

A structured regional approach will ensure more companies are supported to become companies of scale. More local potential investors will be encouraged to become active investors. There will be a greater visibility of success, further encouraging new investors to enter the market.

The regional impact of a properly structured, locally focused co-investment fund can be seen from the data in the table below showing the number of investments made by LINC Scotland members before and after the initial introduction of the Scottish Co-investment Fund in 2004.

[13] See Final Report for Tillväxtanalys (Growth Analysis) on the Recommended Methodologies for an interim Evaluation of the Swedish Regional Co-investment Funds (CIFs), Gordon Murray, Marc Cowling, Markku Maula, March 2015.



We would suggest that a new national investment fund is put in place along similar lines to the Scottish Investment Bank's Co-Investment Fund model, rather than the current UK Co-Fund model. This would be an evergreen, balance sheet based fund which would be managed by the British Business Bank on a regional allocation basis. The public sector partner would invest alongside "accredited partners" from the private sector who would have to meet qualification criteria based on track record and investment processes and personnel. There would be a commitment from the private sector partners to invest on a regional basis, in the same way as the Scottish Investment Bank requires a Scottish based focus for its investment activities.

In effect, many VCT managers would become accredited partners for this purpose, as would some larger angel syndicates. The co-investment fund should consider providing matched investment of up to £7.5m per company on the same basis as the private sector co-investment partner. In the Scottish context, that would complement the investment activities of Scottish Investment Bank in the £0-£2m area while providing leverage to the activities of the expansion stage funders in Scotland.

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

See response to question 9 above. In our view, the market failure which we have identified requires intervention not only through tax relief, but also through co-investment which would leverage private sector investment. This would aid regional economic development and would be more likely to provide an increased supply of suitable companies for later stage scale up investors. These policies if properly combined can increase both capacity and capability of private sector investors.

11. Is there an optimum minimum length of time of investment for entrepreneurs and investors to focus on the long term growth of their company and, if so, what is it?

As highlighted above, in our experience, innovative, high growth potential companies, often take ten years or more from their initially investment round to the point where they become commercially viable or of interest to purely commercial investors. It is therefore important that policy intervention provides as joined up a pathway for companies during that phase, while also allowing early investors to achieve a sensible return and to incentivise them to continue investing in start-ups. The suggestions we have made in this submission would involve relatively small changes to current policy interventions which could have a significant impact on availability of capital for scaling companies.

However, there is no single "optimum minimum length of time of investment" applicable to all companies. The funding period will vary from industry to industry, and from company to company within those industries. The Consultation suggested that "UK investors appear sometimes to exit their investments at a relatively early stage", citing Chart 2.B as showing UK firms receive fewer rounds of private investment before an Initial Public Offering (IPO) or sale to a trade buyer than their equivalents in the US. We do not see this as an issue within the UK context. Harvard Business Review reported research from Play Bigger, a Silicon Valley consultancy that works with VC-backed start-ups, looking at 69 U.S. companies that raised venture capital since 2000 and subsequently went public to see whether the amount raised prior to IPO predicted growth in market cap after IPO, a proxy for long-term value creation. They found no relationship. Indeed companies that IPO early appear to generate most value - "Companies that go public between the ages of six and 10 years generate 95% of all value created post-IPO"[14].

The suggestion that early exits result in a loss to the UK economy holds only to the extent that subsequent economic activity by the acquired entities does not occur within the UK. Research by Scottish Enterprise[15] has highlighted that a key motivation on the part of companies who have been acquired is to facilitate growth as a result of being acquired. Acquisition was not the "end of the company" but rather a trigger for investment of funds material, skills and networks into the company. "*It is evident that being acquired from outside Scotland invariably led to some profits made in Scotland not remaining here. However, it was emphasised in interviews that without the sale taking place, the company would not be experiencing the growth in jobs, in the supply chain and have secured the investment it has subsequently. They would also not have the access to international networks, larger contracts and greater expertise. In the minds of management some degree of profits not remaining within Scotland was an acceptable trade-off in order to secure wider benefits within Scotland for the company – and for the wider economy".*

Fundamentally companies were able to grow faster as a result of being acquired than had they attempted organic growth. While funding is important, growth is ultimately dependent on achieving increased turnover. Being acquired was also seen as providing greater financial security, which in turn enabled companies to compete for larger contracts with bigger companies, in order to yield even greater returns.

The key to ensuring that post acquisition benefits continue to flow to the domestic country is ensuring that the company is "embedded" within the local economy. This depends on a wider range of factor than just quantum of local funding, and issues of skills, public agency support, available expertise, and infrastructure and access to domestic markets must be addressed.

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[14] "Time to Market Cap: The New Metric That Matters," by Al Ramadan, Christopher Lochhead, Dave Peterson, and Kevin Maney

[15] The Role of Acquisitions in Company Growth, A report for Scottish Enterprise, Dr Paul M. Hopkins, June 2014.

The correct time for an IPO or a trade sale is at the “right time” for each individual company. It would not be appropriate to attempt to control this through policy measures, for example by extending the qualifying periods for SEIS / EIS / VCT tax relief.

12. What other steps could government take to make current tax reliefs more efficient and effective, to provide the best support in line with their policy objectives?

The current tax reliefs, along with the changes we have suggested, should provide a more joined up pathway for young, innovative companies to access growth capital.

The effectiveness of these policies in allowing companies to successfully scale would be amplified by leveraging investment activity through regionally focused co-investment funds administered by the British Business Bank. In addition, non-financial interventions, such as relaxation of procurement rules, improved export support, access to talent and focus on the creation and improvement of regional ecosystems will all amplify the benefits of the tax reliefs.