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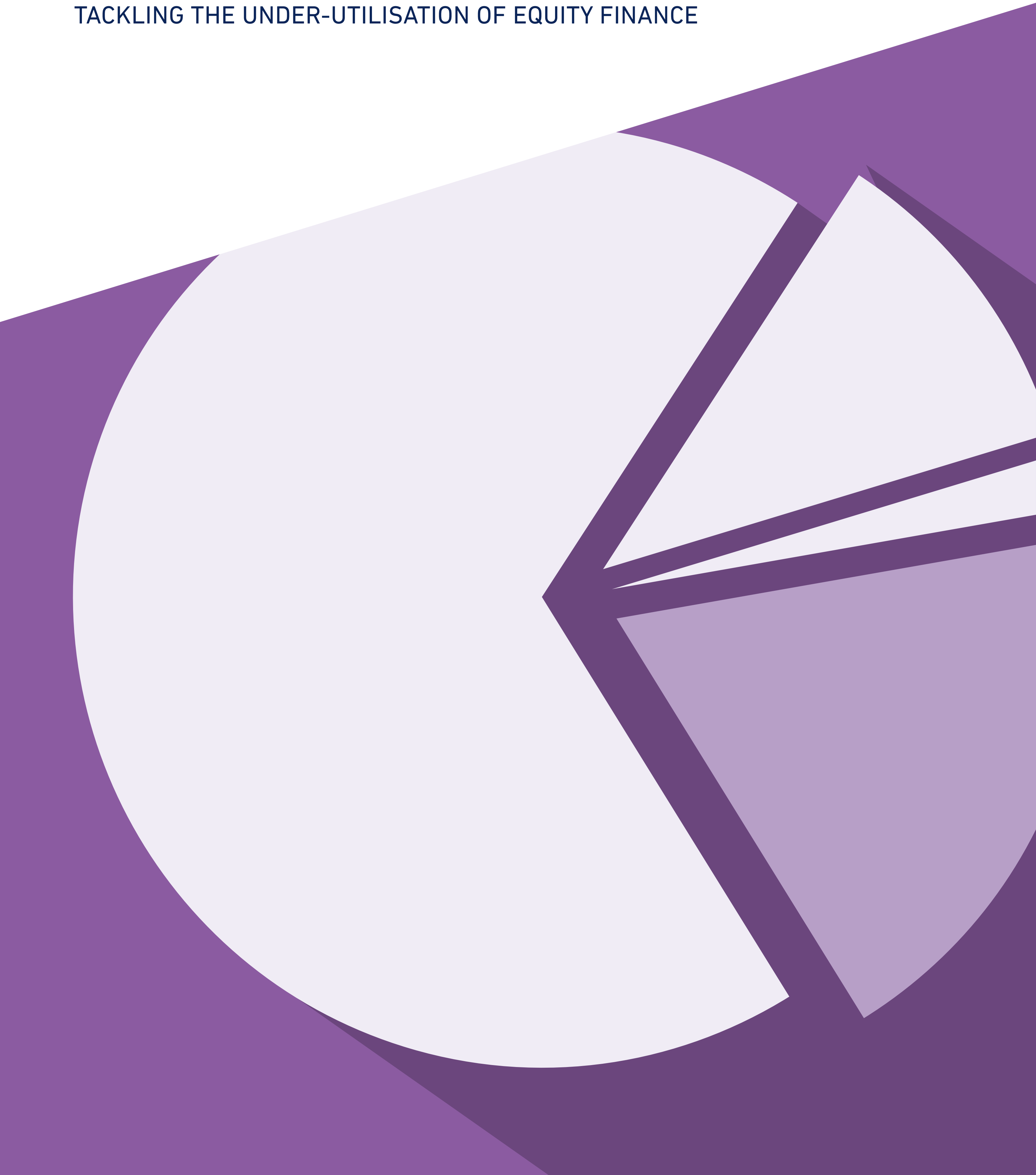
TACKLING THE UNDER-UTILISATION OF EQUITY FINANCE



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David Dickson, Chairman, Garbutt & Elliott
Tony Wilson, Finance Director, Kimal plc
Ludo Bammens, Director, KKR Asset Management Partners LLP
David Bird, Finance Director, LeaseDrive Group
Roger Wood, Director, Midven
Richard Craven, General Counsel, SPTS Technologies Ltd
Richard Sanders, Director, Sullivan Street Partners
Lucy Armstrong, Chief Executive Officer, The Alchemists
Ian Mitchell, Finance Director, The Norville Group Ltd
Dominic Jaques, Managing Director, Tresauris
Duncan Reid, Partner, Watson Burton LLP

CONTENTS

Executive summary

Small and medium-sized businesses are the lifeblood of the UK's economy. In particular, fast-growing, medium-sized businesses have been central to leading the economic recovery, quietly doing much of the heavy lifting in every part of the UK.[1] To continue to support long-term, sustainable growth, these firms must be able to access the finance they need to grow. Equity finance is a proven source of patient capital, but is under-utilised in the UK. This should be addressed as part of wider efforts to diversify the supply of finance available to growing businesses.

Pressure on the financial markets has eased in recent months, with data showing that the availability of finance for growing businesses in the UK is now improving.[2] But anecdotally, small and medium-sized businesses tell us that while access to working capital is easing, there remain challenges when seeking longer-term, patient capital to finance investment and growth.

The CBI believes the financial crisis has put the UK on an irreversible path to a 'new normal' in financing, with regulatory reform, bank balance sheet restructuring and a more realistic pricing of risk changing the nature of lending for the long-term. Critically, the financial crisis is forcing UK businesses to address their historical over-reliance on traditional bank debt – finance that will always play an important part in business lending, but is not always the right option for businesses seeking growth.

In 2013, the CBI published *Ripe for the Picking: a guide to alternative sources of finance*,[3] as part of a long-term campaign to encourage firms to consider a range of finance options. Since then, the take-up of alternative finance options has continued to increase. In fact, the amount lent by alternative finance providers reached £939 million in 2013, an increase of 91% on 2012's total of £492 million.[4] But there is no time for complacency. The overall percentage of finance provided by alternatives remains low and this is particularly the case for equity finance; just 3% of small and medium-sized businesses use this type of finance.

Based on interviews and surveys of investors and growing businesses, the aim of this report is to explore the reasons for this lack of take-up and put forward recommendations to overcome these barriers.

In some ways, our findings are extremely positive. Business leaders with experience of using equity finance are clear on the positive impact equity investment has had on their business, opening up new avenues for other finance and increasing their access to outside advice and skills. However, the perception amongst those not yet using equity finance remains one of caution. In particular, they fear "losing control" of decision-making within their firm.

Alongside the challenge of increasing appetite for equity finance amongst small and medium-sized businesses, our research also identifies constraints on the supply of equity investment at certain stages of their life cycle. In particular, investors need clear exit routes and businesses need more longer-term options than are commonly available.

It is clear there is not a silver bullet, but a focus on boosting demand, while ensuring supply develops to meet it will mean equity finance can play its part in increasing the availability of capital for the UK's growing businesses.

SUMMARY OF RECOMMENDATIONS

To tackle businesses reluctance to use equity finance:

- All stakeholders should proactively promote the benefits that equity finance can bring to a business and dispel the myths. For our part, the CBI will be publishing a new case study on our website every month for 12 months to showcase businesses successfully using equity finance to fund growth
- The Business Bank should develop a mezzanine finance option to help ease businesses concerns about losing control.

To boost the availability of long-term equity finance:

- Government should trial adjusting the criteria of its equity co-investment schemes, such as Business Angel Co-Investment Fund and Enterprise Capital Funds, to ensure that the investments are made for a minimum of five years
- Government should pilot a simple tax incentive to encourage retail investors to hold shares on a longer-term basis
- The Seed Enterprise Investment Scheme (SEIS) must be made permanent
- HMRC must streamline the application process for small and medium-sized businesses to gain Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) qualifying status
- Government should harmonise regulatory rules to ensure that corporate venture capital is treated the same as venture capital for the purposes of regulatory standards
- Government should consider introducing an incentive for businesses investing in their supply chain to boost the supply of corporate venturing.

Their ambition is back, but growing firms still need the finance to realise it

SECTION 1

Small and medium-sized businesses in the UK have ambition to grow

Over the last 12 months it's fair to say the UK's small and medium-sized businesses have been focused on survival. Just 24% of small and medium-sized businesses increased their turnover in the last year.[5]

The good news is that the outlook for 2014 is much brighter. In addition to the CBI raising its growth forecasts for 2014,[6] our small and medium-sized business members are also increasingly positive, with optimism about the business situation rising at the fastest pace since records began in 1988.[7]

Even more encouragingly, these businesses are aiming to grow substantially in the next five years. 54% of businesses responding to our survey are aiming for between 15-50% increased growth, while more than one in four (27%) businesses are aiming for more than 50% increased growth.

To fulfil this growth ambition small and medium-sized businesses need access to external finance

After access to skills, the leading barrier to small and medium-sized businesses fulfilling their growth ambitions is access to finance. In response to our survey, 35% of small and medium-sized businesses noted this as their number one barrier to growth.

With growing businesses sitting on cash-reserves of nearly £126 billion, 6% more than in 2012,[8] it's clear that some businesses will choose to finance growth from their own balance sheet. However, our survey suggests small and medium-sized businesses are increasingly recognising the need for external finance. 46% of respondents said they will use external finance to fund their business growth in the next 12 months, with 51% of medium-sized businesses noting their need for external funds. This increase in demand is being demonstrated more widely, with the Bank of England reporting that demand for lending from medium-sized businesses was up by 14 net percentage points in Q3 2013.[9]

Finance options are increasing for the UK's small and medium-sized businesses, but some gaps remain

After the worst financial crisis since the Great Depression, the UK's finance market is getting back to health and increasingly meeting this demand. In particular, bank lending to small and medium-sized business is improving. While overall net lending fell in 2013, in most part this was due to businesses paying back more than they are borrowing. In reality, gross lending was up by 28% in October 2013 on October 2012, while the cost of bank debt has fallen in recent months for most firms. In the latter part of 2013 lenders reported that spreads on loans to medium-sized businesses fell by 23%.[10]

In response to the increasing appetite for external finance, we're also seeing exciting developments in the finance market. In particular, the availability of alternative debt finance is increasing. The number of debt fund-backed deals for mid-sized businesses tripled in Q3 2013 compared to the start of the year.[11] This includes not just new, innovative forms of finance, such as crowd funding which now accounts for £120m of lending per annum to small and medium-sized businesses,[12] but also the increased prevalence of well-known, but underutilised sources of finance, such as asset based lending which lent 6% more in 2013 than in 2012.[13]

46%

of small and medium-sized businesses will use external finance to fund their business growth in the next 12 months

In May 2013, the CBI published *Ripe for the picking: a guide to alternative sources of finance*, to boost awareness of alternatives to traditional finance, but also to underline the imperative on growing businesses to actively consider a wider range of options.

But while the landscape is improving, the UK's over-reliance on traditional funding routes is hard to shake off. More alternatives may be coming online, but respondents to our survey reported that their sources of finance are predominately those traditional debt options: 50% rely on bank loans, 36% on overdrafts.

This report aims to build on our efforts to boost demand for alternative sources of finance and shine a light on equity finance in particular. It explores the view of equity finance by growing businesses and puts forward recommendations to overcome the under-utilisation of this important source of finance in the UK.

Working capital

Working capital most commonly describes shorter-term finance which enables businesses to complete day-to-day operations such as funding a new contract or paying a bill.

Working capital can help businesses to shore up their cash flow. Debt finance options such as an overdraft and invoice financing are examples of shorter-term, working capital.

Investment capital

Investment capital is longer-term finance, often requiring intermittent draw-downs, which enables businesses to invest in riskier growth activities such as developing a new product or undertaking an acquisition.

Equity finance provides investment capital to growing businesses undertaking riskier activities. There are also debt finance options which provide investment capital such as private placements and retail bonds.

> *"We would have been out of business without equity finance and see it as essential to moving forwards."*

Small construction company in the East Midlands

Equity finance is a proven solution, offering more than money

SECTION 2

Small and medium-sized businesses that use equity finance are positive about the impact on their business

Of those small and medium-sized businesses with direct experience of using equity finance, 68% believe that the investment had a positive impact on their business. As a result, four out of five of these businesses said that they would use additional equity finance to fund their business growth in the future.

These businesses are ready-made advocates of equity finance, with 81% saying that they would recommend equity finance to another business. Businesses with positive, direct experiences of equity finance have an important role to play in raising awareness and understanding of equity finance amongst the wider business community.

CASE STUDY

Founders buy back their business from Peter Jones

Wireless Logic was formed in 1999 by the current Managing Director, Oliver Tucker, and Sales Director, Philip Cole – both highly experienced operators in the telecoms and technology industries. Peter Jones CBE – a major technology investor – acquired the business in 2002.

In August 2011, ECI backed Oliver and Philip to buy back the business from Peter Jones, materially increasing the size of their equity to have a significant stake in the business, but they needed to raise capital to fund this transaction. At the time the business had 3,600 customers and 540,000 connections under management almost exclusively in the UK.

ECI's investment has attracted talent to the business, alongside significant growth. The business now has over 1m connections under management, and has opened offices in France, Germany and Spain. Profits and sales have doubled.

Oliver Tucker, founder and MD of Wireless Logic said:

"Entrepreneurs don't automatically think of private equity as a tool to assist them in gaining a bigger stake in their business and helping them significantly grow their business. My own experience with ECI has been excellent in helping us to buy the business back from Peter Jones, increase our stake and grow the business. Private equity is not a panacea and appropriate for all businesses but should certainly be on the agenda more than it is for ambitious entrepreneurs."

"We would use equity finance again as we believe it is important to match risk and longevity of funding and we want to rely less on debt finance."

Small manufacturer in the North East

Equity investment can allow businesses to take on more risk and reap the returns

Equity finance provides the investment businesses need to fund growth activities and take on risk. Our interviews with small and medium-sized businesses suggest that firms that have used equity finance did so because their plans were thought to be more risky, with over one in four (26%) businesses undertaking M&A activities and a quarter (24%) developing new products with their finance injection.

With risk, so often comes reward; half of businesses that have used equity finance reported that their turnover grew by at least 15% over the course of the investment.

CASE STUDY

Adnams plc – investing for the future

Adnams was established in Southwold, Suffolk in 1872 as a brewer and pub owner. It has since developed its business to include hotels, wine, shop retail and distilling.

Adnams have an equity capital base that has not changed in many years. It includes two types of shares, one of which is quoted on the ISDX market and one which is unquoted and has restrictive transfer rights. The management team believe that this stability has served the business well during turbulent times for brewer/pub owners such as Adnams because the equity structure provides some safeguards against irreversible transactions taking place on the basis of temporary market sentiment.

Adnams have made substantial investments in the business over the last ten years, replacing old and inefficient plants and relocated distribution operations to the outskirts of Southwold. Investment has focussed on environmental improvements and long-term sustainability. Adnams have also built a chain of shops and a distillery over this period.

Stephen Pugh, Finance Director said:

"The beer business has been undergoing radical change in the last few years. Overall consumption has been gradually declining, drinking at home has gained relative to drinking in pubs and beer styles have changed. Recently we have seen cask ales make a modest comeback against the long term rise of lager. Having a solid long-term supportive equity base has been vital in giving us the confidence to invest, to brew new styles of beer, to add a distillery and to demonstrate our environmental commitment and credentials."

Equity investment can help attract other sources of finance

If the business requires additional finance for working or growth capital, our findings suggest equity investment can assist in attracting other sources of finance. One in four (26%) businesses which have used equity finance reported that equity investment helped them to gain additional external finance and our interviews confirmed this. Other financiers often report that equity investment gives them confidence in the business' ability to grow and to repay the finance which in turn enables them to provide finance to businesses which may have otherwise been too risky.

CASE STUDY

LeaseDrive grows with duel support of private equity and debt finance

LeaseDrive, a fleet management and vehicle rental service company began in 1983 and by 2003 remained a small player in the contract hire market. However, after changes to the senior management team and development of a new financial strategy the business growth accelerated.

LeaseDrive's first experience of private equity was to support a merger in 2007. In 2008 the management team and the investors began the process to find a suitable new investor with the appetite and financial muscle to help LeaseDrive grow further.

During this process LeaseDrive met with the team from Lloyds Development Capital (LDC) in Reading and a secondary buyout deal with LDC was completed in 2008, supporting the management with equity investment while RBS provided a senior debt facility. Shortly after the deal was completed, the financial crisis struck, but the management team and investors agreed that the crisis provided opportunity for LeaseDrive to grow through acquisition. In 2011, supported by LDC, LeaseDrive acquired a long established fleet management business which immediately doubled the size of LeaseDrive's turnover without increasing debt or diluting equity.

Since then LeaseDrive has continued to go from strength to strength with a fleet size of over 40,000 units and turnover in excess of £130m.

David Bird – Managing Director says:

"We are very proud of the business we have built and extremely happy with the excellent support offered all along the way from LDC. Private equity often gets a bad reputation for being short sighted and not caring about the business. Our experience could not be further removed. We are very proud of all of our achievements so far – we bought into a business back in 2003 which had little or no profile. Ten years along the way our business has won an array of awards, employs 275 people, operates a fleet of over 40,000 vehicles on behalf of its superb "blue chip" customer base and has turnover in excess of £130m.

Equity investment can provide a number of non-monetary benefits to the business

Alongside providing cash, our research shows equity finance also provides a number of additional benefits. 39% of the businesses that have used equity finance say that their ambition has increased as a result. In fact, 42% of businesses that have used equity finance have ambition to grow more than half in the next five years, compared to just 19% of businesses who do not. By boosting ambition, equity finance can leave a legacy of growth in the business which stretches beyond the initial investment period.

CASE STUDY

Public equity provides Velocys with patient capital

Velocys (formerly Oxford Catalysts Group) is a leading technology innovator. It designs, develops and commercialises technology for the production of high quality liquid fuels from waste gas (which would otherwise be flared or reinjected), unconventional gas, stranded gas and renewable sources.

The company listed on the AIM market of the London Stock Exchange in 2006. At the time it employed approximately 20 staff, but has subsequently expanded to employ around 100 employees. It listed on AIM to raise capital for a reverse takeover of a US company. It has since raised further growth capital, including a strategic launch in September 2008 – a time when the capital markets were extremely unpredictable – and further issues in 2011 and 2013.

The key challenge for Velocys in coming to market was the need to demonstrate their technology to attract investors and maintaining that investor support – companies like Velocys need investors who believe in the product. The success of Velocys has been built on its possession of a compelling technology and its record of delivery. It has repeatedly set and then met targets, giving investors' confidence in the company's management. Each equity launch has been successful because it can demonstrate progress.

Susan Robertson, Chief Financial Officer said:

"It was essential that Velocys raised growth capital through an equity issue. Bank finance was not appropriate because the timing of our future cash flows was uncertain. We have a good relationship with our bank, but it would be unrealistic to expect a bank to fund a technology that is still in development and not expected to lead to a return in the near future. It's important for us to maintain liquidity in our stock, so we welcome the forthcoming abolition of stamp duty on AIM shares from April 2014, which will provide a liquidity boost."

81%

of small and medium-sized businesses that have used equity finance would recommend it to another business

Small and medium-sized businesses value the wider business support often offered by equity investors. 44% of businesses considering using equity finance said that if the investor worked in partnership with them then they would be encouraged to use it. Equity investors, recognising the importance that businesses place on a partnership approach, are increasingly prepared to work in partnership with the business to share the challenges and opportunities of growing a business.

In particular, businesses accessing equity finance value the external expertise equity investors can provide; one in five businesses currently considering using equity finance said that if an investor could offer new expertise to the business they would be encouraged to use this type of finance.

Autonomy is also key, 36% of businesses which have used equity finance said that they chose an investor because of their partnership approach to investing. This approach to the investor and investee relationship allows the CEO to be supported, but ultimately responsible for the day-to-day activities of the business while strategic, board level decisions are agreed together to take the business forward in the right direction.

CASE STUDY

Vita Liberata – premium health and beauty company goes global

Vita Liberata is a premium self-tan brand that is manufactured and distributed from the company's head office near Belfast. The company, established in 2003, is a family-run business.

In 2011, the company recognised that there were significant international growth opportunities in Europe and North America and in early 2012 the company had the opportunity to launch its range of products in a chain of cosmetics stores across Europe. Investment was required to support this launch, to introduce a new product range and to recruit additional senior personnel to provide the international support the business required.

Broadlake Capital, a Dublin headquartered private investment group, identified the potential of the company and the strength of the management team and invested in the business in March 2012.

Broadlake's investment provided the capital to fund its continued international expansion. In the 18 months since investment, Vita Liberata has more than doubled its turnover, has doubled its product range and is in the middle of a recruitment drive for an extra 50 members of staff.

Following a hugely successful launch in Europe, Vita Liberata secured a multi-million pound contract in North America in late 2012. 46% of the company's sales in 2013 were exported outside of the UK to 22 different countries. In addition to capital, Vita Liberata has benefitted from Broadlake's financial, operational and strategic support in delivering this impressive international growth.

Alyson Hogg, CEO of Vita Liberata, said:

"Taking equity investment was the best thing we could have done for the business. We discussed funding with various parties but with Broadlake we believed we would be entering a true partnership where we would be supported to grow. Since taking our funding we have become unrecognisable as a company. Giving up part of the business is always painful, but with the right partner it can be the most rewarding of steps. In our case it gave us the opportunity to fulfil our global ambition."

Tackling the barriers to equity investment

SECTION 3

Despite the overall positive experience of growing businesses, just 3% of small and medium-sized businesses use external equity finance in the UK[14] which lags behind the EU, where an average of 7% use equity finance. It's also far behind countries like Sweden and Norway, where 36% and 40% of businesses use it respectively.[15] But while a comparison on equity investment with other countries can be useful, the UK needs to find its own path to boosting finance.

Our research points to a number of barriers resulting in the under-utilisation of equity finance in the UK. The following pages set out the problems and offer proposals for tackling these issues head on.

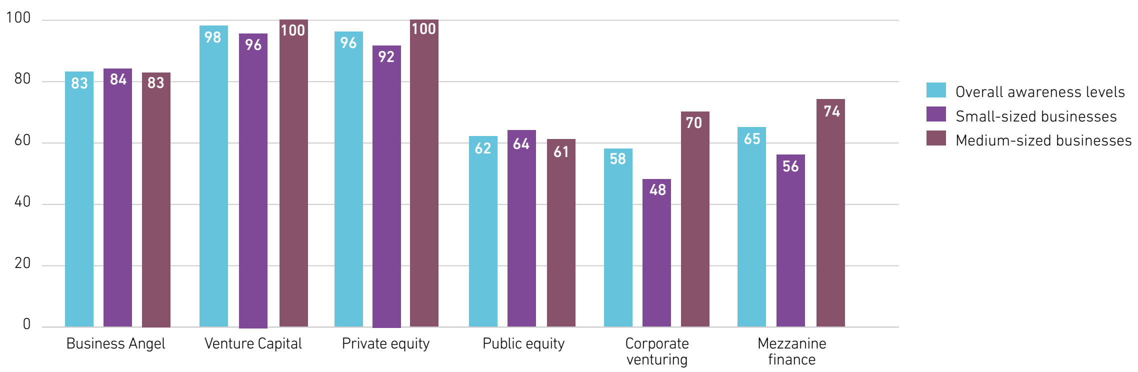
Businesses awareness and capability to engage is a barrier to take-up of equity investment

Our survey found that amongst businesses who have not used equity finance overall awareness of equity finance is high, with 77% of businesses being aware of the different types of equity finance. However, there is a mixed picture when we look at the awareness of different types of equity finance (see **Exhibit 1**). In particular, awareness of venture capital and private equity investment is very high amongst small and medium-sized businesses. As expected medium-sized businesses are more aware of the various forms of equity finance than smaller businesses, but their awareness of the types of finance which can provide the next stage of financing, such as mezzanine and public equity lags behind.

Awareness and understanding of the range of finance options available to small and medium-sized businesses is key to obtaining the right type of finance. This includes a business' ability to strategically review and assess their finance need and submit an effective application. In short, to ensure the finance provider can assess the risk effectively. This is crucial because not only do equity investors have more detailed information requirements, there is often a negotiation of terms not usually seen with debt finance. These requirements can be a challenge for small and medium-sized businesses:

- Just 25% of small and medium-sized businesses have a formally qualified financial manager, meaning the resource and skills to do equity deals is often not held internally[16]
- In general, small and medium-sized businesses resist using external, independent advisers to guide them through financial decision-making; 84% do not consult external advisers before making finance decisions[17]
- Small and medium-sized businesses are time constrained; 57% spend less than an hour researching finance providers before settling on a decision.[18]

Exhibit 1: Awareness of the types of equity finance available



46%

of businesses not considering using equity finance reported concerns about losing ownership

In interviews investors told us that firms often have difficulty meeting the information requirements to attract equity investment which, combined with a mixed awareness and understanding of equity finance, acts as a significant barrier to increased demand for equity finance. Both businesses and investors agree that early relationship-building between businesses and investors is key. Investors will usually need to take the lead in cultivating these relationships, building a pipeline of investment opportunities, but also playing a crucial role in raising awareness and understanding amongst growing businesses.

In addition, our research suggests that businesses also have a role to play. Small and medium-sized businesses must take ownership of their relationship with their finance provider, or potential provider, in the same way that they would manage other crucial supplier relationships. The most successful growing businesses develop a plan to review their finance needs as part of a cycle each year and maintain regular engagement with their finance provider, or prospective provider throughout the cycle.

The current landscape for Government advice and support to facilitate an increased awareness and understanding of equity finance amongst small and medium-sized businesses, alongside boosting their internal capabilities, is difficult for businesses to navigate and access. We support moves to bring all Government finance support under the remit of the British Business Bank and would welcome equal support shown to debt and equity finance.

Business owners need reassurance that equity doesn't mean losing control of their business

According to our research, the biggest barrier to improved demand for equity finance is the perception oflosing ownership. 46% of businesses not considering using equity finance reported concerns about losing ownership.

Coupled with this is a concern about a loss of decision-making power; one in five businesses not considering equity finance said that was their main concern. Selling a minority stake is therefore an appealing option for small and medium-sized businesses. Of those businesses that are considering using equity finance 35% said that the investor taking a minority stake would encourage them to use equity finance.

The good news is that investors are increasingly bringing flexibility to their investments and are prepared to invest minority stakes. For example, Business Growth Fund, which was established in 2011, invests growth capital, but will only take a minority stake. Entrepreneur's Relief also acts to encourage business owners to take-up equity finance by selling some of their shares, but requires HMRC and the British Business Bank to align their efforts to promote Entrepreneur's Relief much more enthusiastically.

Mezzanine finance has the potential to act as a bridge between debt and equity finance. By reassuring businesses that it is possible to sell a minority stake without ceding control and losing decision making power. However, as the market is currently underdeveloped, the British Business Bank should develop a mezzanine finance option to help ease concerns about losing control.

RECOMMENDATIONS

- All stakeholders should proactively promote the benefits that equity finance can bring to a business. The CBI will be publishing a new case study on our website every month for 12 months to showcase businesses successfully using equity finance to fund growth
- The British Business Bank should develop a mezzanine finance option to help ease concerns about losing control.

Equity finance must meet the long-term finance needs of growing businesses

Growing businesses rely on long-term finance, in particular finance that can be drawn down intermittently and invested for five years or more. Although there are investors providing this type of finance, our research shows most equity finance deals are done on a medium-term basis; half of business angel, venture capital and private equity investments made to small and medium-sized businesses were for less than five years. Nearly half (48%) of businesses considering equity finance said that they would be encouraged to use equity finance if the investment was long-term.

There is no single solution to attracting long-term investment. Instead, a range of fiscal and regulatory measures, including rebalancing the tax system, is needed to encourage retail, household and institutional investment flows to growth companies. We believe making it easier and cheaper to invest in small and medium-sized businesses is key to improving investor confidence and addressing the limited supply of patient equity capital. In 2014 the CBI will be undertaking a review of the tax gap that growing businesses face, identifying solutions to minimise the cost compliance and complexity burden.

To boost the supply of patient capital Government should trial adjusting the criteria of equity co-investment programmes to ensure that some investments are made for a minimum of five years. In addition, retail investors have an important role to play in supporting the stability of a business' equity base, and as part of a diversification of investors in small and medium-sized businesses. However, our research shows that small and medium-sized businesses in particular are disrupted by investors holding shares for only a short time. To encourage individual investors to support businesses in the long-term Government should pilot a simple tax incentive for retail investors holding shares for at least five years.

RECOMMENDATIONS

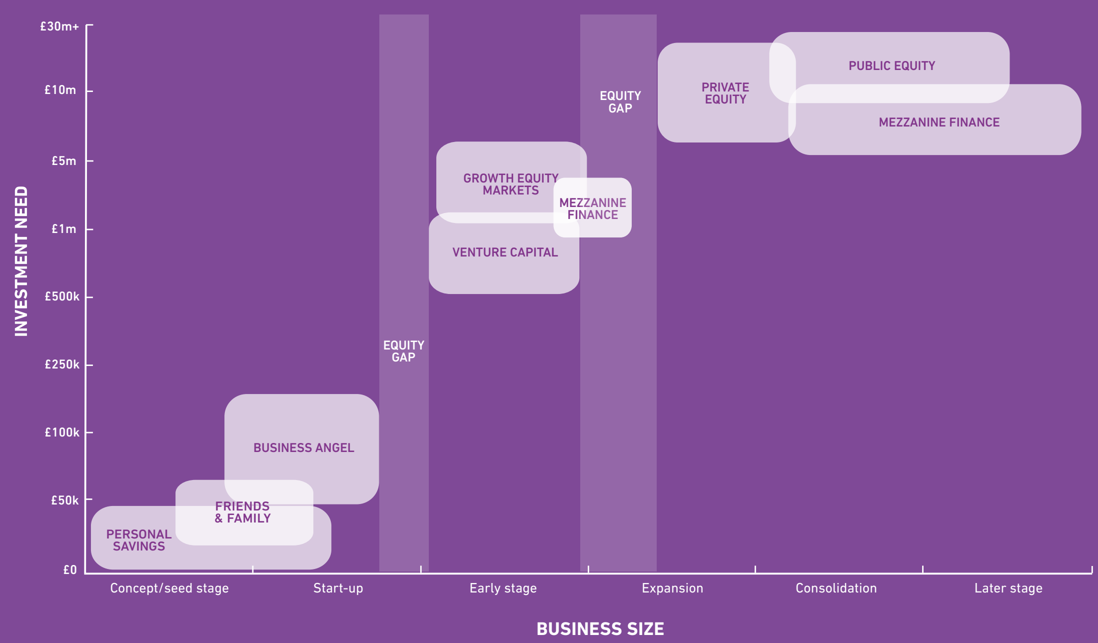
- Government should trial adjusting the criteria of a portion of additional equity co-investment schemes including Business Angel Co-Investment Fund and Enterprise Capital Funds to ensure that the investments are made for a minimum of five years
- Government should pilot a simple tax incentive to encourage retail investors to hold shares on a longer-term basis.

The market will be more attractive to investors and growing businesses if exit routes were clearer

Part of the reason for shorter investment cycles in equity finance is the lack of options for investors when they wish to exit.

The funding journey of a small or medium-sized business from innovative start-up to becoming a well-established business, enjoying continued growth and expansion, is often described as a 'funding escalator' or 'funding ladder' (see the equity funding ladder overleaf). The ladder suggests that as businesses grow, their equity finance will progress from stage to stage, with equity investors playing a role at different stages of a business's growth journey.

THE EQUITY FUNDING LADDER



Our research suggests many businesses do not follow a linear growth journey, and do not necessarily take all of the steps, in that order, but the analogy remains useful for broadly describing a route many businesses will use, as well as the exit points at which most equity investors will exit.

A fully operating equity ladder will support high-growth small and medium-sized businesses throughout their life cycle, and provides a clear exit cycle for investors, but our research suggests the UK's ladder has a number of missing rungs. In particular, there are two established, structural financing gaps in the UK equity market that must be addressed: businesses seeking between £250,000-£1m and those seeking finance between £5-10m. This particularly affects businesses at certain stages in their growth cycle. Businesses making the leap from start-up to early stage and then those early stage businesses moving into expansion mode.

Our anecdotal evidence suggests that there can be reluctance amongst equity investors to conduct secondary or tertiary deals which can limit the exit routes available to equity investors. In 2012 of all venture capital and private equity divestments, just 9% were a sale to another private equity firm.[19] We need to tackle the culture which views secondary or tertiary deals as a failure. Increasing links and relationships amongst equity investors and organisations such as the Business Growth Fund could boost investors' willingness to complete secondary or tertiary deals to support businesses in their growth journey.

EIS and SEIS will remain crucial to the supply of early stage equity investment

For early stage businesses the UK business angel market is the most active in Europe.[20] The UK Business Angel Association quantifies UK angel investment as £850m per annum, with approximately 18,000 angels engaging with small and medium-sized businesses.[21]

Although the financial crisis caused a slump in venture capital investment, seeing it fall by 32% between 2007 and 2009[22] other countries also experienced significant falls in supply, with the US market shrinking by 26%.[23]

The supply of venture capital is now showing signs of recovery; in 2012, investment in venture capital to UK companies increased, with the amount of investment rising from £492m to £708m.[24] However, it isn't time to celebrate the return of the market just yet. The amount of venture capital invested in UK companies declined by 15% in the first half of 2013, compared with the previous year.[25] In addition, although the UK compares well with the rest of Europe when measured as a proportion of GDP, UK venture capital is less than half the size of the US industry.[26]

EIS/SEIS are extremely positive, well received schemes, supporting the supply of business angel and venture capital investment in small and medium-sized business. Since 2012 over £82m has been raised by companies through SEIS, with the average deal investing £72,000.[27] Meanwhile the long standing EIS has supported companies raising over £9.7bn of funds since 1993/94.[28] The schemes can be stretched to further support high growth businesses. Gaining EIS/SEIS qualifying status from HMRC is an administrative and cost burden for the investee, so HMRC must work to streamline this process to ensure that qualifying businesses are not disproportionately burdened and that deals are not delayed. To further support the supply of early stage equity finance by providing investors and businesses with stability and surety on the tax landscape Government must make the SEIS permanent.

In addition, EIS is currently restricted for investment in companies who have acquired Intellectual Property (IP). With many of the UK's fastest growing businesses reliant on knowledge and IP, like our world-beating creative industries, the Treasury should review the rules on venture capital investments to see whether such restrictions are having unintended consequences.

RECOMMENDATIONS

- SEIS must be made permanent
- HMRC must streamline the application process for small and medium-sized businesses to gain EIS/SEIS qualifying status.

Private equity has rebounded but we need to address its perception issues

Private equity took a similar hit during the crisis, with availability falling by over £1bn between 2008 and 2009.[29] Anecdotal evidence suggests that providers of equity finance are looking to do fewer, but more expansive deals which is symptomatic of increased risk aversion in the market post crisis. The supply returned quickly with the number of investments increasing by 4% in 2010, with the value of investment increasing by 72%, offsetting the decline in 2009.[30]

We need to re-shape the public debate on private equity's role in helping UK firms realise their growth potential. Too often, private equity is associated with short-termism and accusations of asset stripping. Government and other stakeholders could help by recognising private equity as part of the solution, rather than part of the problem. Investors should also commit, alongside the CBI, to work with politicians and the media to tackle the perception issue.

Public equity markets must continue to offer an established path for growing firms

First-time equity issuance fell away during 2008 and 2009 and remained low in 2010 and 2011. There was an increase in public equity issues by companies that had previously raised finance on public equity markets during this time, but that can be largely attributed to firms needing to reduce leverage rather than financing new projects.[31]

2013 has seen a sea change in both the demand for public listings from growth businesses and the willingness of investors, both retail and institutional, to buy and sell equity shares. In Q2 2013, there were 11 listings on the London Stock Exchange's Alternative Investment Market (AIM), compared to five in Q1.[32] For businesses quoted on AIM, increases in liquidity have boosted the performance of their shares. In August 2013, the average daily value of traded shares was £98.8m, a 24% increase on August 2012.[33]

Policy changes have helped with the success of these markets in recent years. Since August 2013, stocks and shares ISAs can be invested in securities quoted on growth equity markets, such as AIM and ISDX. From April 2014, stamp duty on AIM and ISDX quoted shares will also be abolished. Both of these measures are making the markets more attractive to a wider range of investors and will contribute a valuable boost to the level of trading that takes place in the shares of smaller quoted companies.

Corporate venturing should be a viable form of equity finance, but it is under-utilised in the UK

Trade sales are becoming increasingly important for all types of equity investment across the business life cycle. The British Venture Capital Association (BVCA) reports that the volume of trade sales is increasing, from 13% of all venture capital and private equity divestments in 2007 to 20% of divestments in 2012.[34] In 2011 the UK had the third most active corporate venturing market, with the US the most active, followed by China, the UK, India and Germany.[35] However, the UK remains far behind the US, from the start of 2012 until mid-2013 £300m was invested in the UK in corporate venturing capital, compared to $757m in the US.[36]

With an estimated £488bn[37] on their balance sheets, corporates have the ability to invest. In addition, small and medium-sized businesses that are estimated to have £120bn of cash on their balance sheets[38] are beginning to recognise the importance of supporting their supply chain by using equity investment coupled with strategic support. Businesses of all sizes have a role to play in supporting their supply chain through minority equity stakes.

It is clear that corporate venturing has an important role to play in the equity ladder, but if the UK does not take action now we will fall behind our international competitors and this important source of equity finance for small and medium-sized businesses will dry up.

There are steps that Government can take to maintain and boost supply of corporate venturing in the UK. Currently some regulatory rules provide a disincentive for both the investor and investee, such as small and medium-sized businesses being disqualified from using R&D tax credits if they are backed by corporate venturing investment. Government should therefore take steps to harmonise regulation to ensure that corporate venture capital is treated the same as venture capital for the purposes of regulatory standards. In addition, Government should consider introducing an incentive to enable businesses of all sizes who invest in their supply chain to benefit.

RECOMMENDATIONS

- Government should harmonise regulatory rules to ensure that corporate venture capital is treated the same as venture capital for the purposes of regulatory standards
- Government should consider introducing an incentive for businesses investing in their supply chain to boost the supply of corporate venturing.

> *Equity finance adds value and management focus.*
>
> **Medium-sized business in West Midlands in the retail and leisure sector**

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For further information or a copy in large text format, please contact:

Laura Smith
Senior policy adviser
T: +44 (0)20 7395 8043
E: laura.smith@cbi.org.uk

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