CBI RESPONSE TO THE LABOUR PARTY'S START UP REVIEW

CALL FOR EVIDENCE - AUGUST 2022

Introduction

The CBI welcomes the opportunity to respond to The Labour Party's Start up Review Call for Evidence. The UK is a world leading place to start a business[1]. However, with growing international competition, this status needs to be maintained and built upon. Our scale ups drive the UK's growth, adding £1trillion to the economy, despite accounting for less than 1% of firms[2]. But we need to support more of our start-ups to scale up. This is a vital prize for a new Government to focus on, which can enable companies to fulfil their growth potential and contribute to the UK's economic success. Units like the Office for Science and Technology Strategy are showing promising signs and could provide the cross-department Governmental support our innovative high growth businesses need.

The CBI is the UK's leading business organisation, speaking for some 190,000 businesses of all sizes, sectors, and regions, that together employ around a third of the UK private sector workforce.

Recommendations:

1. The Government should work with the financial services sector to raise awareness of financing options for growth in order to encourage more businesses to develop a plan and ambition to grow.
2. The Government should continue to build on the British Business Bank's success and continue the replacement of existing European Investment Fund SME finance through new funds.
3. The Government should look to identify routes to develop deeper and improved liquidity so that these markets can play a greater role in helping to increase the supply of patient capital.
4. The Government must continue to provide these enterprise tax incentives and consider how to better promote them to ensure more firms can benefit.
5. Venture capital schemes eligibility should be reviewed to include high risk activities, such as sharing economy asset leasing.
6. The Government should expand the R&D tax credit to include Capital Expenditure as an allowable expense.
7. The Government should assess the merits of staggering tax incentives, where incentives increase the longer the investment is held.
8. The Government should encourage the formation of university clusters capable of creating a critical mass of investment potential for a given region.
9. There must be a more systematic approach to commercialisation within UK Research and Innovation (UKRI) to ensure that ideas and businesses do not fall through the cracks of support.
10. Each government department should be required to allocate budget towards Small Business Research Initiative (SBRI) projects and to publish information on what steps they have taken in support of the 2.4% R&D target.
11. Government should support and progress the Procurement Bill which aims to reduce red tape, reward value and support innovation.

[1] Generation Covid: How the pandemic shaped the start-up landscape (CBI, 2022)
[2] ScaleUp Annual Review (ScaleUp Institute, 2021)

Response to questions:

1. What more can we do to ensure new and growing businesses have access to capital, and in particular patient capital?

The UK has a world-leading financial services sector which helps provide the finance necessary for the UK's business community and the wider economy. Many businesses which have reached the scale-up stage now require patient capital to fulfil their long-term growth plans. The UK financial services sector offers a myriad of financing options for a growing business, both debt and equity based, with equity relatively under-utilised by SMEs. However, these financing options need to be exploited by strengthening the connections between financial services and growth firms in order to unlock long-term growth.

Analysis shows that while the gap between US and UK funding of early-stage businesses is relatively small, this gap increases significantly for later stage funding. The analysis also shows that UK businesses receive fewer rounds and smaller amounts of subsequent funding compared to similar firms in the US. The most significant drop off is between third and fourth rounds, with the analysis showing that of the firms measured, 32% received three rounds of funding. Only 9% of all firms analysed participated in a fourth funding round[3]. Getting growing firms to continue fund-raising activities is fundamental in ensuring that the UK economy unlocks its true potential and is firing on all cylinders.

Medium-sized businesses make a disproportionate contribution to economic growth, representing just 1% of businesses they generate 15% of private sector revenue and provide 13% of total employment[4]. Enabling these businesses to succeed will be crucial to economic growth, and given the right opportunities and incentives the Government can help even more businesses grow, creating a strong foundation for the future, post-Brexit economy.

The CBI is aware that many small and medium sized businesses choose not to scale up, only 36% of SME's use external finance, and nearly 8 in 10 of businesses that do not access external finance are defined as 'happy non-seekers of finance'[5]. Clearly not all businesses' goals include growing to scale.

Recommendation: Therefore, the Government should work with the financial services sector to raise awareness of financing options for growth in order to encourage more businesses to develop a plan and ambition to grow.

Government has a significant role to play in building on success and enabling current private and public initiatives to do even more.
The financial services industry has been successful in developing a number of options to finance a growing business. It is clear however, that the Government has a significant role to play by enabling these successful private and public initiatives to do even more. It is important to build on the success of initiatives that have already been set up, such as the British Business Bank (BBB) which has supported £89bn of finance to small businesses[6] as well as the private sector-led Business Growth Fund.

Recommendation: The Government should continue to build on the BBB's success and continue the replacement of existing European Investment Fund SME finance through new funds.

To help build a patient investment culture in the UK, short-term public investment is required to encourage long-term private investment.
The British Business Bank is vital to unlocking the future growth of firms, and the allocation of extra resources to the Bank is pivotal in fulfilling this role. To complement this, public initiatives must go hand in hand with private initiatives in the long term to avoid crowding out private investment. CBI members agree that the current Government's role of facilitating the private sector has been successful in recent years through such initiatives as the Business Growth Fund, and would encourage any new Government to build on this success in the future.

---

[3] Small Business Finance Markets, (British Business Bank, 2017)
[4] Business Population Estimates (BEIS, 2021)
[5] SME Finance Monitor, (BDRC Continental, 2017)
[6] Annual Report (British Business Bank, 2021)

Public-private partnerships, for instance, could allow institutional investors to co-invest effectively in patient capital whilst building their own expertise of investment, leading to their own direct investment into funds in the future. Engaging with businesses through further consultation is important for ensuring the right strategy is adopted to foster a dynamic and vibrant long-term investment culture. This strategy must identify the right structure for these funds to avoid the risk of State aid considerations and adding further burdens on the exchequer.

A well-functioning small cap market can create a direct source of patient capital for growth firms, and gives private investors, angel investors and actively managed funds a route to exit and therefore greater confidence to invest in these listed companies. Small cap markets are typically less liquid.

Recommendation: The Government should look to identify routes to develop deeper and improved liquidity so that these markets can play a greater role in helping to increase the supply of patient capital.

A number of barriers must be overcome to encourage greater patient capital investment by pension funds in the long-term.
CBI members support the long-term objective of greater investment by pension funds in patient capital. However, for reasons identified below, pension funds should not be treated as an investor category that can make a significant contribution to closing the patient capital gap in the immediate term.

Understanding the need for liquidity
Some CBI members feel that the risk averse nature of pension funds as a major barrier to further investment in patient capital has been overstated. For trustees of defined benefit pension schemes, a tendency, in some cases, towards traditional asset classes is driven by prudence owing to a need for schemes to be liquid, rather than low-risk behaviour. The profile of defined benefit savers, who are on average closer in age to retirement than their defined contribution counterparts, and therefore, more likely to "cash-out", and the transfer options open to scheme members, means liquidity is a necessity. Schemes approaching maturity need to be capable of quickly settling liabilities or possibly paying transfer values to members. CBI members believe that improved liquidity in the UK's small cap market could be one route to address this.

Growing investor confidence with a greater level of research
A principal barrier to investment cited by some CBI members is the lack of research, and therefore, transparency, in relation to patient capital. This is thought to have contributed to an unfamiliarity with the asset class and the merits of investing in patient capital amongst some trustees and advisers.

Taking the right approach to consolidation
Members suggested that consolidation of pension schemes could have a positive impact on funds' ability to adopt more sophisticated investment strategies – however, it was felt that this should be considered a long-term solution, and certainly not a silver bullet. Given that CBI members identify scale as a factor limiting investment power, to be effective, consolidation would need to consist of a genuine pooling of investment funds.

A dual approach, rooted in both demand and supply side policies, is required in order to boost long-term investment attitudes.
The UK is home to a world-leading and dynamic financial services sector, offering a range of financing options to firms with an ambition for growth. It is essential to be mindful of all sources of finance when looking to increase the effective supply of patient capital.

CBI members acknowledge that there is a large amount of investment capital available. However, getting the demand side right is critical for any business. While the CBI recognises that not all businesses want to embark on a risky and uncertain journey of long-term growth, it would be foolish to label UK firms with a lack of ambition. With the right awareness, network and management skills, we have the potential to unlock multiple success stories across the UK.

In some specific instances, CBI members can have the best management skills and long-term strategies and still do not get the long-term finance they need. A significant barrier to seeking long-term investment is anchored in misinformation, poor communication and a lack of awareness of the finance options available to firms. Building on successful initiatives such as the London Stock Exchange Group's ELITE programme and Goldman Sachs' 10,000 Small Businesses programme, there is a collective responsibility to ensure that those firms with the long-term drive to achieve more have the right tools and information at their disposal to make the most attractive propositions possible. We recognise that the CBI has a role to play in encouraging this education.

The CBI recognises the emotive aspect of dilution and business control when deciding whether to seek equity investment, and the Government must lend its weight in profiling its benefits to ensure growth firms are given the best chance of long-term success. This can be achieved through groups such as Local Enterprise Partnerships (LEPs) across England, Scottish Enterprise or Invest Northern Ireland, which offer useful channels of communication to firms across the UK, to ensure they are best equipped to navigate their investment journey.

The CBI realises that it is not just the role of government to ensure firms are better informed of the finance options available. The business community can play a useful role in connecting businesses with investors. Building on the trust and relationships that already exist, especially in supply chains, larger companies could provide a route to patient finance for smaller firms, in some cases, being the finance provider. These collaborative long-term strategies between businesses would improve trust and visibility across the supply chain, and open up new markets for the growth firms.

2. Do we have the right incentives for growing businesses in the UK, and how do they compare to other countries?

Essential tax-advantaged programmes must be protected to help fulfil firms' long-term growth ambitions and provide much-needed certainty to businesses.
CBI members frequently highlight the value of tax-advantaged programmes like the Seed Enterprise Investment Scheme (SEIS), the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs), which incentivise investment in start-ups and support the provision of finance to early-stage businesses which investors deem to carry more risk for investors. In addition, Business Property Relief for Inheritance Tax (IHT) is also valuable for family-owned businesses, enabling them to focus on growing and investing in their business rather than retaining profits to ultimately pay an IHT bill.

Recommendation: The Government must continue to provide these enterprise tax incentives and consider how to better promote them to ensure more firms can benefit.

Businesses across the UK value the benefit that schemes such as EIS can bring by way of incentivising investment. Excluding business activities from the scheme can make it even harder for firms to attract investment, as Bundlee found, due to the exclusion of asset leasing from EIS and SEIS. The example highlights how the scope of venture capital schemes can have a profound impact on the ability of firms to raise finance.

Recommendation: Venture capital schemes eligibility should be reviewed to include high risk activities, such as sharing economy asset leasing.

The Government can help create a tax environment that enables small and medium sized businesses to make long-term investments and to innovate through R&D tax credits. Increased R&D supports higher economic growth and greater tax revenue through the creation of thousands of additional high-value jobs every year and innovations that are valuable to consumers, businesses and government alike. Bringing capital within R&D tax credits would provide much needed funding for early stage and innovative businesses to make long-term investments in facilities and equipment that would support multiple R&D projects, making the UK a truly competitive hub for innovation.

Recommendation: The Government should expand the R&D tax credit to include Capital Expenditure as an allowable expense.

The current suite of tax incentives has been essential in increasing and sustaining investor appetite in a challenging economic environment. However UK needs to maintain its reputation as a great place to invest and develop a long-term investment culture on the supply side.

Recommendation: The Government should assess the merits of staggering tax incentives, where incentives increase the longer the investment is held.

3. Do universities have the right skills, structures and incentives to allow them to successfully spin out and grow businesses?

Universities can play an even greater role in optimising investment across the UK through regional alliances.
Our universities play a vital role in ensuring the future success of our country – whether that's as anchors within their local communities helping to boost regional growth, at the cutting edge of new teaching and research methods, or in expanding our links abroad. Businesses consistently cite the strength of the UK's academic research base as an attractor to invest in R&D in the UK, and collaboration is a core part of many businesses research strategies. This is reflected in global businesses forming long-term strategic research partnerships with universities across the UK in relevant areas of specialism.

University members of the CBI have stated that in order to attract investment outside of London, informed investors need to be presented with a critical mass of opportunity, as the Midlands Innovation alliance universities are able to do. A critical mass of well-selected and well-presented investment opportunities will make for a more attractive proposition to investors, and similar regional alliances across the UK could stimulate growth and increase the number of spin out company jobs. For example, the SETsquared Partnership of universities, which includes Bath, Bristol, Exeter, Southampton and Surrey, has incubated 1,500 high-tech start-up companies during the past 15 years, helping them to raise more than £1.25bn of equity financing.

Recommendation: The Government should encourage the formation of university clusters capable of creating a critical mass of investment potential for a given region. This could be done by offering regional patient capital funds through an enhanced BBB, that specifically looks to partner with universities in order to retain the regional identity that is often so important for growth.

An increased focus on development and commercialisation is needed to ensure the benefits of UK research are realised.
The quantum of funding, rigidity of time frames and notice periods for UKRI R&D funding rounds and disproportionate bureaucracy limits the UK from realising the potential of its investment. The UK's development and commercialisation capabilities are consistently highlighted by businesses as an area that must be improved within the UK Research Development and Innovation ecosystem.

The skew of public R&D funding towards research limits the ease of development and commercialisation of new technologies and limits the ability of researchers to leverage cutting-edge science and technology to do more commercially oriented R&D and to do it at pace.

Recommendation: There must be a more systematic approach to commercialisation within UK Research and Innovation (UKRI) to ensure that ideas and businesses do not fall through the cracks of support.

Testing and demonstration capabilities or facilities are often a vital step in route to market. But rarely will one company alone be able to fund or host such a facility or function. They often involve 'live' real world environments, so may need regulatory flexibility or local Government buy in, or they are too expensive for one company to fund and see a return but have wide sector applicability. Availability of and access to testing and demonstration facilities, as well as a means by which to support strategic investment in new capabilities, is a key gap in the UK's current offer. A business demand-led route for funding new testing and demonstration capabilities where it is in line with strategic priorities could be developed.

4. How do we improve access to public procurement for start-ups?

There is currently a lot of red tape and confusing procurement processes that can be cut.
Identifying, understanding, and bidding for Government contracts takes time and resources that many start-ups do not have. Bidding for multiple contracts involves entering the same information in different formats multiple times, thereby wasting valuable resources. To overcome this, red tape needs to be cut. By reducing the paperwork required to bid for public contracts and investing in digital procurement systems. As well as ensuring all public contract opportunities are advertised in a clear and accessible format, and that public bodies regularly engage with the market.

We need to reward value rather than lowest cost.

There is a focus on lowest cost rather than value for money. Despite guidance to the contrary, many public bodies still procure solely on the basis of lowest initial cost for cultural or capacity reasons. This means that the quality or the social value of a business is only a secondary consideration in award decisions. Start-ups often have a significant quality offering or an inherent social value due to their place within a local economy/community, but these characteristics are not rewarded. Instead procurement needs to reward value instead of lowest cost. By providing training and support for public bodies to ensure clarity on the need to procure for value for money rather than lowest cost. As well as encouraging the use of social value in procurements and amending the definition of social value to include existing or inherent social value, rather than just the additional social value brought to a contract.

Innovation should be supported through procurement.
Public procurement has failed to procure innovation. Too often, public bodies either do not understand or are not able to procure for innovative goods and services due to a lack of commercial capabilities or cultural behaviours. This leads to innovative offerings, like those offered by start-ups, not being considered in the design or procurement processes. To rectify this we need to make early market engagement a mandatory part of the commissioning design process to help public bodies understand what the potential solutions available are before going to a procurement process. Adopt a less prescriptive attitude to procurements and invite start-ups and other suppliers to be a part of the early design process. The small business research initiative (SBRI) is also a well-established process to connect public sector challenges with innovative ideas from industry. It is underused.

Recommendation: Each government department should be required to allocate budget towards SBRI projects and to publish information on what steps they have taken in support of the 2.4% R&D target.

Recommendation: Government should support and progress the Procurement Bill which aims to reduce red tape, reward value and support innovation.

5. How do we ensure we have a better geographical distribution of start-up high-growth businesses across the UK?

Regions and nations have the best understanding of their local economies and should be driving their growth.
Greater devolution and empowering local leaders should form the bedrock of this strategy, but the Government should set the overarching ambition.

Access to finance needs to be easier for those outside of the South East.
The range and density of providers, agents and influencers which are a feature in London is not replicated elsewhere in the country. Venture capital funding is focussed on firms located in London and the South East, with 72% of UK funding directed to this area[7]. This is led by venture capital investors' own location, with the majority located within the South East: there are 973 investors in London, while no other region or Nation has more than 80[8]. There is, therefore, a need to increase the range of providers and investors actively engaging in the regions and being aware of the investible opportunities which exist. These are critical early steps to support a re-tilting of resources to build a stronger and deeper private sector business base in each region of the country

Access to skills is a problem for all firms and can be more acute in lower paid areas.
The latest CBI Industrial Trends Survey shows 2 in 5 (39%) businesses say access to skilled labour is likely to constrain activity over the next three months – far higher than long-run average. This can be more problematic to high growth firms in lower wage areas, who have trouble recruiting and retaining high skilled talent.

Infrastructure needs to be improved to enable better connectivity.
Without timely, cost efficient and reliable services, regions struggle to present themselves as attractive bases for start-ups to invest and expand. Digital infrastructure is also key priority for many start-ups, with access to superfast broadband and mobile connectivity often cited as a barrier to growth in the regions, especially coastal and rural economies.

[7] Report on Investment Activity (British Private Equity & Venture Capital Association, 2021)
[8] Small Business Finance Market Reports 2021/22 (British Business Bank, 2022)

6. Should we be encouraging more firms to list in London? If so, how?

CBI members welcome initiatives that encourage companies to list in the UK and note the benefits that a vibrant global public market, attracting well-run companies from around the world, provides for the UK economy, businesses and jobs.

A flexible and proportionate regulatory approach is needed to encourage deeper capital markets that support growth and innovation.
The depth, scale and global reach of the UK's capital markets, where shares, bonds, and other financial instruments are traded, and the confluence of global investors and intermediaries play a critical role in financing business growth, managing risks and investments. UK equity markets are among the deepest and most liquid in the world. There are currently over 1,100 companies listed on the London Stock Exchange's Main Market with a capitalisation of around £3 trillion.

It is vital as the UK forges a new global future and seeks to unlock growth and investment that there is a flexible and proportionate regulatory approach that is agile enough to cope with changing technologies and global shifts.

There has been an increasing shift in recent years towards fast-growth technology, e-commerce and science companies coming onto public markets, versus more traditional industries. The Alternative Investment Market (AIM), the world's leading growth market, already allows fast-growing companies to float shares with a more flexible regulatory system than is applicable to the main market. A shift in approach to make it easier to list, ensuring more a more accessible and flexible system will in turn contribute to create an ecosystem that helps all businesses whilst attracting high-growth innovative firms.

A proportionate, globally competitive listings regime will unlock growth and investment.
The CBI support the position that a continued evolution of a diverse listing offer within the UK is a key component of being internationally competitive. The market should enable a means to raise finance and to trade equity, providing for a diverse range of capital raising and investment opportunities for all. Proportionality should be considered in light of streamlining the listing process to find routes to make it more attractive to growing businesses as a route to financing their growth ambitions. And on the reverse proportionality should also be considered to find ways of increasing investor participation across all segments from premium to AIM.

A proportionate listings regime must play a critical role alongside a robust institutional framework to replace EU regional funds, wider tax and regulatory reform such as the Solvency II Review to unlock UK pension capital and attract in foreign institutional and private investment.

Such a regime will help to foster an innovative culture that encourages businesses to seize the opportunities presented by a wider range of finance options to unlock growth and investment.

For any further queries please contact kapila.perera@cbi.org.uk