



MARCH 2020

Unlocking Growth

How to Expand Access to Capital

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EnterpriseTrust



**THROUGHOUT THE REPORT,
WE'LL SHOWCASE STARTUPS
AND SMALL BUSINESSES
WHO HAVE USED EXTERNAL
FINANCE TO MEET THEIR
GROWTH AMBITIONS.**

A report by



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"This report suggests some small policy tweaks that could make a big difference in changing perceptions and opening opportunities."

FOREWORD



Richard Harpin is the founder of the UK's leading home repairs and improvements business HomeServe, who funds the work of new 'think and do tank' The Enterprise Trust.

All evidence points to the fact that businesses that take on board investment at key moments in their growth trajectory do dramatically better than those that don't.

These founders go on to create jobs, generate taxes and contribute to UK economic growth.

What's astonishing, and what this report highlights, is that applying for and receiving necessary funding has often become so complex that it has left almost one in ten founders discouraged to the extent that they don't apply in the first place, when they really should.

This leads to unnecessary business failures and a £1.5bn hole in investment.

For many, it's simply a case of a lack of understanding of the kind of funding that's most suitable for them. For others it's the perception that they can't spare the time it takes to apply and the persistence they believe is required to get investment. Or that they feel they would be unsuccessful; or all of the above.

What is clear, is that the message that seeking investment is very complicated has been understood by many in the small business community.

What hasn't landed so well, is the message that in the right circumstances, funding is transformative – and vital.

But it's great to see that the alternative lending market is expanding its facilities and maturing to offer help to more start-ups and that this is starting to make a difference.

The businesses I invest in via my private investment vehicle Growth

Partner are testament to this fact. Yes, we look very carefully at those that we invest in, but that for those that are successful, it takes them to another level altogether.

With a little more thought and a lot more awareness about the funding options open to small businesses, this unhelpful statistic could be turned around.

This report suggests some small policy tweaks that could make a big difference in changing perceptions and opening opportunities.

These include:

- Modernising R & D tax credits to increase innovation.
- Streamlining advance assurance for EIS and SEIS to make this a more efficient process.
- Providing more long-term patient capital by reforming the British Business Bank's approach .
- Making it viable for defined contribution pension funds to invest in venture capital.

What's clear is that finance is out there. What is also clear is that it's not always getting to where it needs to be. This report points to some big ideas that, if adopted, could change this.

“Without access to external finance many businesses can fail unnecessarily.”

INTRODUCTION

In many ways, starting a business has never been easier or cheaper. For some entrepreneurs, all they need to get started is a laptop and a wi-fi connection. In such cases, bootstrapping – growing without seeking external capital – might be attractive. Relying on friends and family alongside any personal savings you have may allow you to keep control while starting out, but it limits your potential to grow. On top of that, cashflow issues affect most businesses. Without access to external finance many businesses can fail unnecessarily.

Yet navigating the array of funding options can be challenging. Polling suggests almost one in ten entrepreneurs are discouraged from seeking external finance, even though their businesses have real funding needs.¹ However, the rise of alternative finance providers, alongside tax incentives for early-stage investment, have created new opportunities for businesses to access the funding they need to grow.

This report has two aims:

- To demystify the funding landscape and inform entrepreneurs of the financing options available to them.
- To identify policy changes that could unlock new funding opportunities for entrepreneurs.

As there is no ‘typical’ business – we avoid making one-size-fits-all recommendations. Instead, we highlight the advantages and disadvantages of each funding option. For instance, traditional lending options may be ill-suited for a pre-revenue research-intensive tech startup. Similarly, some entrepreneurs might not be comfortable with the growth demanded by venture capital investors.

Throughout the report, we’ll showcase startups and SMEs who have used external finance to meet their growth ambitions. We ask founders about the lessons they have learnt through the process, the advantages and disadvantages of different funding options, and the advice they would give to other entrepreneurs.

Before we discuss the options available to entrepreneurs, we are going to take a deeper look at the problem of discouraged borrowers. What barriers do they face? Are they driven by perception, or are there gaps in the market?

¹ Brown, R., Liñares-Zegarra, J., and Wilson, J.O.S. (2008) An empirical Examination of discouraged borrowers in the UK, ERC Research Paper 69.

“As there is no ‘typical’ business, we avoid making one-size-fits-all recommendations. Instead, we highlight the advantages and disadvantages of each funding option.”



DISCOURAGED BORROWERS

Discouraged borrowers are SMEs with a real need for finance, but fail to apply due to fear of rejection, a belief that raising capital would be too expensive, or concerns the process would be too difficult or time-consuming.

Using Department for Business, Energy and Industrial Strategy's (BEIS)'s Longitudinal Small Business Survey, Brown et al (2018) find that 9.3% of SMEs (131,130) fit that description. One recent study finds that over half (55%) of this group would have been successful if they had applied.² It is estimated that discouraged borrowing results in a £1.5bn annual investment shortfall, leading to fewer jobs and weaker economic growth.³ Put differently, borrower discouragement lowers investment by £11,439 on average per affected firm.

Female, older, and ethnic minority founders are over-represented among discouraged borrowers. Female founders, in particular, are twice as likely to be discouraged compared to male entrepreneurs.⁴ This may be due to different risk perceptions and a reluctance to seek equity investment when it might be the most appropriate source of finance. However, this may be changing as women have made substantial progress over the past decade in closing the equity funding gap.⁵

Investment readiness may be another issue. Owen, Mason, and Pierrakis (2018) note that discouraged borrowing can result from a lack of understanding of which types of finance are appropriate for their business.⁶ They observe many early-stage venture finance applications fail when startups present a value proposition ill-suited to venture capital.

Awareness of the full range of financing options may be an issue. When SME founders identify a need for finance, they are most likely to go straight to their main bank. Polling commissioned by the British Business Bank finds that only a small minority of businesses speak to accountants, other entrepreneurs, or research finance products on the internet.⁷ Almost two-thirds (64%) of SMEs "don't know anything about" equity finance.⁸

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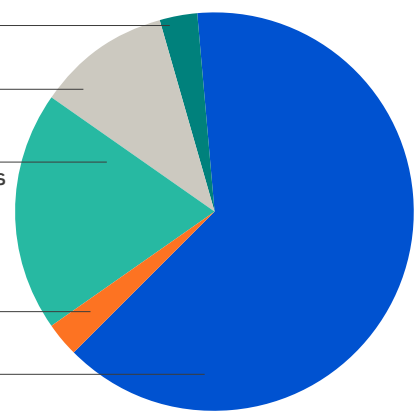
3.0% wouldn't know where to start.

11.1% reluctant to give up control.

19.2% do not think it is suitable for them.

3.0% use or plan to use in near future.

63.6% don't know anything about.



Source: BVA-BRDC, SME Finance Monitor.

Networks may play an important role in tackling borrower discouragement. Business owners will be better able to organise a search for external finance options if they have access to advice from other business owners who have been successful in accessing finance, and relationships with business angels and seed investors. For example, the Goldman Sachs 10,000 Small Business programme combines 100 hours of expert tuition from business schools with networking opportunities to boost the growth of high-potential businesses. Participating businesses were four times (71%) more likely to seek external finance than the average UK small business after completing the course.⁹

"Awareness of the full range of funding options may be an issue."

² Ibid.

³ Ibid.

⁴ Ibid.

⁵ Denham, A. (2019) Here and Now: Making the UK the Best Place in the World for Female Founders. The Entrepreneurs Network.

⁶ Owen R, Mason C and Pierrakis Y (2018) Is alternative finance the panacea for early stage SMEs? The UK case for improved regional policy coordination. Paper to the ISBE conference, Birmingham, 7th November.

⁷ British Business Bank (2019) Small Business Finance Markets 2018/2019.

⁸ BVA-BRDC (2019) SME Finance Monitor: Q2 2019.

⁹ The Scale-Up Institute. Goldman Sachs 10,000 Small Businesses.

CASE STUDY: FRANCIS TOYE FOUNDER, UNILINK

Unilink is a medium-sized software company with 150 staff. Francis Toye founded it in 1994 after 16 years at IBM. Last June they won a contract with the Norwegian Justice Ministry to develop and supply all of their prison and probation software. Unilink will become the leading European and possibly world supplier of justice offender management software.

Toye benefited from the Goldman Sachs 10,000 Small Businesses programme. "Fundamentally I felt that we had plenty of opportunities, but that we did not know how to grasp them and had reached a point where the business was stagnating and not growing fast enough. I was quite frustrated trying to find a way to grow the business. Although I made a reasonable salary each year, the business could be described as a 'lifestyle business' making a nice living for the owners rather than one that would change the world. Looked at as an outsider, I had taken a massive risk, started a business but needed to learn many things to get out of the rut we were in."

Toye used his savings and borrowed from his family to start the business. Since participating in the Goldman Sachs 10,000 Small Businesses programme he has borrowed £1m from Funding Circle, 75% of which they have repaid, and borrowed £7m from the sellers of a business that they purchased with defined payment terms over a period of time. "Today we owe about £3.5m which will be repaid over the next two years but we are considering more finance to increase our R&D spending to develop new riskier ventures," says Toye.

"The best thing of all is meeting other like-minded entrepreneurs," says Toye of the Goldman Sachs 10,000 Small Businesses programme. "They are inspirational! Learning that you have the same problems and that you have a group with whom you can share them is brilliant. When asked what was the biggest thing he learnt: "Sounds basic but if you want to grow a business you have to work really hard. When I saw how much harder other people were working I tried to match them."





DEBT VS EQUITY

A key choice for businesses seeking external finance is whether to take on debt or sell equity. Each method has its own advantages and disadvantages. The right choice will depend on the business model, stage of growth, and the long-term goals of the founder.

Debt involves borrowing money from a lender and then paying it back, plus interest, in regular instalments. Raising through debt enables founders to fund growth without diluting ownership. Debt financing can typically be arranged quickly.

By contrast, a founder raising finance through equity will give up a stake in their business in exchange for funds. A key advantage of equity finance is that there is no requirement to make regular monthly repayments. As a result, businesses with financing needs that are pre-revenue or have unstable revenues, will prefer to use equity.

Equity investors typically want to realise the value of the investment on an exit event, such as an acquisition or IPO. As a consequence, equity investors typically are more tolerant of risk and invest for the long term. A business would not usually turn to equity finance to meet a short-term financing issue. Debt, on the other hand, is more versatile. It can vary from the use of credit cards and overdrafts to cover day-to-day expenses, to the use of bank loans to finance to purchase equipment or renovate premises.

One potential issue with equity investment is alignment of incentives and ambition. As equity investors are looking to maximise the value of their stake on exit, it can lead to

conflict over strategy. For instance, a founder who does not share the same growth ambitions as the investor may be pushed towards a more aggressive growth strategy.

Founders should ask themselves the following key questions to determine the right type of finance for their business.

Am I seeking short-term working capital or long-term growth?

If you are seeking finance to fund day-to-day costs (known as working capital) such as wages, rent, or inventory, then debt will be more appropriate. Short-term debt, such as credit cards and overdrafts, are well-suited to the task. The average SME is owed £6,142 in unpaid invoices. In such cases invoice finance (see case study) could help.

If you are seeking long-term finance, more options open up. You can seek a loan using traditional banks, direct lenders, or even peer-to-peer (P2P) lenders. Alternatively, you can seek equity investment either through angel investment, equity crowdfunding or venture capital.

Am I generating revenue and do I have a trading history?

Lenders may ask for a trading history and revenue forecasts. If your business is pre-revenue or forecast to run losses in the near future and there is a high risk you will not be able to

“The average SME is owed £6,142 in unpaid invoices. In such cases invoice finance could help.”



keep up with monthly repayments, then equity may be more suited to your funding needs. In some cases, venture capital can enable loss-making businesses to grow for years before becoming profitable.

Do I have assets I can secure a loan against?

Not all lenders will require you to secure your debt against assets, but if you are unable to put up assets as security then you will typically face higher borrowing costs.

IP-intensive businesses may prefer to use equity finance over debt as lenders find it difficult to value intangible assets, such as patents.¹⁰

If you do have assets that you can secure a loan against, then you can access larger fundraising opportunities through debt.

Do I need support (e.g. advice) alongside finance?

A key benefit from equity finance is the potential to gain trusted advisers committed to the success of your businesses. They may alert you to further funding opportunities, connect you with new clients, or help you with business strategy. In the case of angel investment, business angels often have experience as entrepreneurs and typically offer their time and guidance, alongside cash.

What size of investment am I seeking?

The type of finance right for your business depends on the size of the investment you are seeking. For example, early-stage businesses may be better off looking at pre-seed or angel investors for small (e.g. £50k or less) raises. For investments between £100k and £500k, equity crowdfunding or peer-to-peer lending may be appropriate. While for founders seeking investments upwards of £1m, venture capitalists (VCs) or specialist direct lending funds are the main options.

What are my long-term ambitions?

If your investors do not share your long-term vision, then you are setting up for conflict down the line. Some founders aim to build revolutionary businesses that disrupt markets and employ thousands – for them, the sky is the limit. While other founders seek an exit within five to ten years, and expect to be acquired by a larger business. Finding investors who share your objectives is important. VCs tend to seek to realise their investments over longer time-frames (8-12 years) providing patient capital, while partnerships with angel investors tend to last for between three to eight years.¹¹

If you want to maintain control and are wary of growing too fast, then taking on debt may be preferable to diluting equity.

¹⁰ Haskel, J. (2019) Capitalism without capital: understanding our new 'knowledge' economy. Bank of England.

¹¹ Haley, C., Van Blitterswijk, D., and Febvre, J. (2019) Paths to Scale: Finance lessons from European entrepreneurs. Nesta.

CASE STUDY: PAUL ADRIAN FOUNDER, MOJO HAIR

MOJO Hair is a British premium hair styling and grooming range for men made in Preston and Alton. "I set up the business in 2014 as I had been made redundant at the age of 49", says its founder Paul Adrian. "With a real mop of hair I didn't think there were any products in the market that delivered in terms of performance, style and fragrance. A chance comment by my wife, who said that all of my hair products stank and why didn't I buy something that smelt like my aftershave, gave me my Eureka moment."

Adrian spotted a gap in the FMCG sector for "affordable but premium hair care products." The MOJO Range of four products is now available in Sainsbury's, Waitrose and Ocado. In addition, the brand is part of Sainsbury's Future Brand accelerator programme.

MOJO also has significant sales internationally: particularly Australia, New Zealand, Russia and India. Half of his business revenues are from export markets, so he has turned to MarketFinance's invoice finance facility for multi-currency invoices / trades.

Paul found "launching the product into retail stores was hard going on his cashflow". Because of long supply chains and payment terms, cash in the business becomes squeezed. Having invoice finance – £300,000 from MarketFinance – means the business can finance itself against guaranteed revenue, helping to fund its growth.

"As an entrepreneur I have made myself aware of all available finance options by reading numerous business publications and the internet," says Adrian. "Initially I bootstrapped and funded the business myself until I had initial listings with Ocado and the Hut Group. I raised cash via SEIS and EIS at earlier stages in the business and was lucky enough to get investment from Andrew Gerrie, the co-founder of Lush Cosmetics and Chairman of Hotel Chocolat," says Adrian. His other two shareholders are friends from his five-a-side vets football team who both run successful businesses.

"We gained listings in 300 Sainsbury's stores and I needed to pay my suppliers and buy more stock asap, so the opportunity to get hold of my own cash in 48 hours and not wait 60 days was a no brainer! In addition, the process was easy to understand and incorporate into the business. Many of the big retailers now see invoice financing as a natural process of doing business with them and there is nothing better than having cash in the bank as opposed to waiting 45-60 days for it," says Adrian.

As the value of his company has increased, he's looked at both short- and long-term loans for funding. "I don't want to sell any more shares in the business, so we have funded it via loans from Funding Circle (which again was a great process that delivered speed to market), bank overdrafts, and credit cards

Adrian is looking to launch a number of additional MOJO products towards the end of this year, and raise additional finance to launch into the US in 2021. His advice to other entrepreneurs is to "constantly review all of their potential funding options as they grow, especially if it means that they hold on to the equity in their business, and discuss funding options with brokers and other entrepreneurs."

"The opportunity to get hold of my own cash in 48 hours and not wait 60 days was a no brainer!"

GRANTS

Grants can be an option for the founders of early-stage businesses who do not want to give away equity or take on debt. As they do not have to be repaid they can be attractive for startups that are pre-revenue. There are over 75 different grant schemes available to SMEs listed on gov.uk, ranging from business development grants to funding for high-risk innovation.¹²

Grants typically have strict eligibility criteria and many are only open to businesses within a specific region. Founders may also be reluctant to apply for grants due to the paperwork involved. In many cases, businesses outsource the process of applying to a third-party specialist. However, this typically reduces the total funding available.

Grants may be appropriate for innovative businesses that cannot access external finance without a proof-of-concept. Innovate UK, the government's innovation agency, has invested over £1.5bn in 5,000 innovative businesses since 2007. They offer a range of grants for SMEs to test and

develop new products in areas including the Internet of Things (IoT), biomedical sciences, and agriculture.¹³ Innovate UK's SMART grants are a £25m fund to support SMEs developing "game-changing and commercially viable innovative or disruptive ideas". SMEs can apply for between £25,000 and £500,000 in funding (and more if they partner with a larger business). The scheme has been found to be good value-for-money by independent evaluations, generating £5 worth of benefits for every £1 invested, but concerns have been raised by business owners that the funding process is opaque and complex.¹⁴

POLICY IDEA: EXPERIMENT WITH LOTTERY-STYLE FUNDING TO CHANNEL MORE GRANT-FUNDING TO STARTUPS

Many startups would benefit from Innovate UK's SMART grants, but the application process can be complex and time-consuming. One grant-writing consultant stated "I'd class Innovate as one of the simplest processes around compared to those in Europe, but even then, it's difficult for a business to navigate... for them, it's almost like speaking Greek reading some of the documents".¹⁵ As a result, some innovative startups choose not to apply.

Intense competition for oversubscribed grant schemes – in some cases there are 1,200 companies bidding for £20-25m – pushes startups to spend a lot of time on the grant-writing stage or turn to external experts. The cumulative application costs to all applicants could represent a sizable proportion of the grant. For example, if eight startups all spend 2.5% of the total grant awarded at the application stage, then the cumulative grant-writing costs spread across all startups applying would be one-fifth of the grant awarded.

The problem may result from the fact that the experts are required to pick between multiple good proposals. A new approach, funding lotteries, may reduce administrative costs. Under the system judges would still weed out unsuitable applications, but after that funding would be allocated at random. New Zealand's Health Research Council uses this approach to allocate funding to proposals that are "transformative, innovative, exploratory or unconventional, and have potential for major impact". A majority of researchers who applied for the grants favoured the lottery system.¹⁶

While not a grant per se, Research and Development (R&D) Tax Credits can be a lifeline to early-stage innovative ventures. The SME Tax Credit enables businesses with 500 or fewer staff, and a turnover of less than €100m, to receive a

super-deduction on their R&D costs. Businesses can deduct an extra 130% of their R&D spending from their taxable profit. If that exceeds their profits, they can instead claim it as a tax credit worth 14.5% of their losses.

12 You can use the "Finance Finder" on <https://www.businesssupport.gov.uk/>

13 They also offer low-interest innovation loans of up to £10m.

14 SQW, Cambridge Econometrics, and BMG Research. (2015) Evaluation of Smart: Impact and Process Evaluation.

15 Boland, H. (2019) Inside Innovate UK, the Government's 'innovation agency'. The Daily Telegraph.

16 Liu, M., Choy, V., Clarke, P., Barnett, A., Blakely, T., & Pomeroy, L. (2020). The acceptability of using a lottery to allocate research funding: a survey of applicants. *Research Integrity and Peer Review*, 5(1), 3.

CASE STUDY: TAMSIN (TAMMY) KOLOWSKI CO-FOUNDER, NAF! STUFF

Tammy Koslowski runs three businesses within the Nail Industry: NAF! Salon, an insta-famous Nail art & Nail Care bar; NAF! Stuff, a vegan & cruelty free hand & nail care brand; and NAF! School, a nail training academy.

Koslowski has 18 employees aged 21 to 32 across the three businesses. Their roles range from nail technicians, nail experts, educators, salon management, operations, customer communication and social media. She also outsources a lot of roles like accounts, graphic design and HR.

She found out about Scottish Edge a few years ago through some peers but it wasn't right for her business at the time. "I'm part of the Royal Bank Entrepreneurial Accelerator and my Scale Acceleration Manager, Gill Rattray, mentioned the competition in one of our monthly check-ins when I was airing my frustrations with our cashflow," says Koslowski.

Koslowski received the £100,000 which was a 60/40 loan and grant. "The funding was to enable us to scale up our production and re-launch NAF! Stuff into a pro product and create a consumer line, which is what we're working on at the moment."

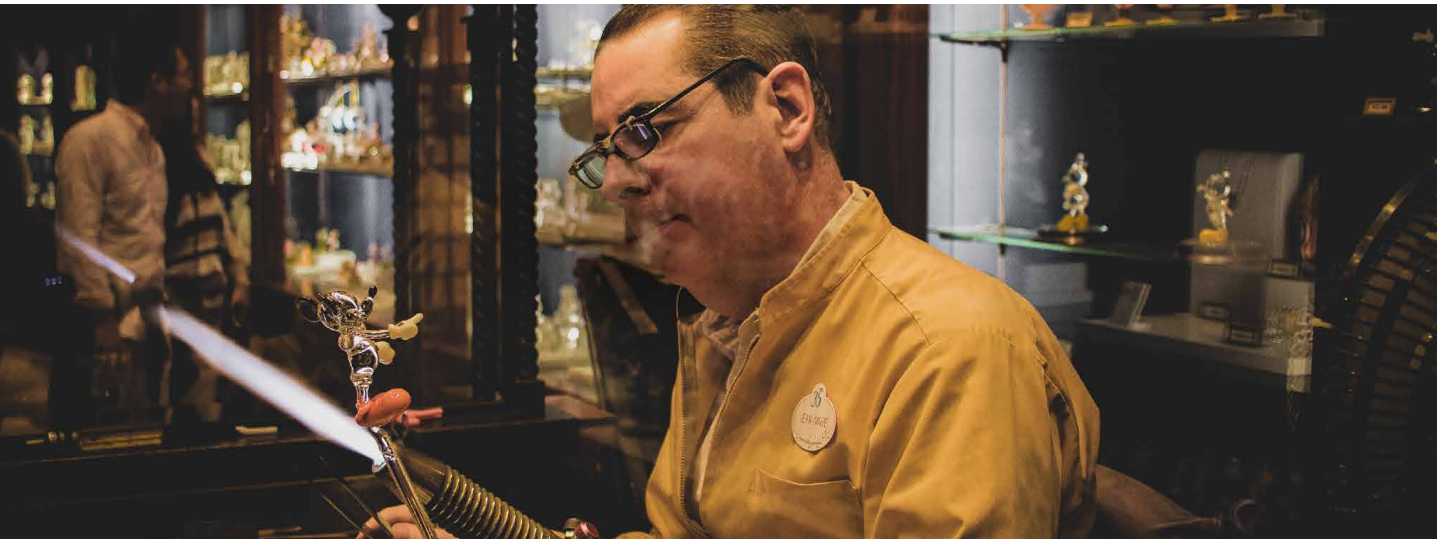
It wasn't just about the grant and loan – a lot of support came with the money. "Once you've won the competition you sit down with your relationship managers and go through your initial application and costings so they can help you put together a timeline and figure out where you need support from their extended network. You also get an Edge package with their partners, which can range from discounted services to one-to-ones with industry experts, which I have found so useful as it's given me access to people at the top of their game to help push my business forward."

Koslowski has also received a £5,000 grant from Scottish Enterprise in 2019 for the R&D costs of developing her products, and previously used PayPal Working Capital Loans and family loans: "which I would personally advise against!"



"I'd urge anyone out there looking for funding to look into your options and shop around," says Koslowski. "I used to use instant loans as a quick and easy option, and I was always scared of "answering to someone" or getting feedback about my business plans. Those loans worked for me at the time but the interest was high and I didn't quite understand the value of taking the time to assess how the funding (and possible repayments) would impact my business in the future."

Koslowski says she has "now learned that funding takes time because you need to sit down and form a plan, think ahead, challenge your ideas and be challenged – the process of competing in Scottish Edge forced me to step back and take the time to analyse how my business was running, form a plan, and evolve. It isn't always just about the money and a lot of the time you realise you need more or even less than you initially thought. I thought I needed £25,000 at first, but after figuring out the direction I wanted to go in and getting final costings back from our manufacturer we actually needed to go for the full £100,000."



Since 2012, when the £10,000 minimum expenditure requirement was eliminated, the number of SMEs applying for the first time has more than tripled.¹⁷ A survey of UK tech startups by Coadec found that the relief, while popular (58% had used it) and valued (69% said it was important to their startups growth and survival), was seen as complex and time-consuming to apply for.¹⁸ A further problem is that many activities that startups consider essential to research do not qualify for the relief.

“Grants may be appropriate for innovative businesses that cannot access external finance without a proof-of-concept.”

POLICY IDEA: SIMPLIFYING AND MODERNISING THE R&D TAX CREDIT

The R&D Tax Credit is valued by SMEs, but could be improved on three fronts: feedback, speed, and scope. Solving these problems would enable more startups to benefit from the relief, and reduce the risk of startups turning to specialist tax credit advisers who can take up to 25% of the relief claimed.

Startups want certainty when dealing with the tax system. If an application fails, startups should be provided with clear and consistent feedback explaining why. Under the status quo, startups find the process complex and may be put-off from re-applying if they do not fully understand why they failed in the first place.

Delays in the processing of applications can have a large impact on early-stage businesses, which place a premium on free cashflow. Coadec polling found that the approval process took 28 days or more for over half (57%) of claimants. HMRC should aim to reduce the length of the approval process, and provide better guidance to startups on how long the process takes.

A key driver of complexity in the R&D Tax Credit system is a lack of clarity and guidance over what counts as a qualifying expenditure. The most recent guidelines were published in 2010 and are of limited assistance to startups innovating in data science or AI. Many expenditures SMEs consider essential to their R&D work either do not qualify or it is not clear whether they qualify. For instance, the use of cloud services is essential to startups working with data, but accountants and advisers differ as to whether they partially qualify, if at all. On a similar note, launching an innovative new app will require testing with users, but startups cannot fully claim for user interface and user experience development costs.

¹⁷ Coadec (2019) Credit Where Credit's Due.

¹⁸ Ibid.

205

incubators in the UK.

163

accelerators in the UK.

>5k

Number of startups across the UK to participate in accelerator programmes.

INCUBATORS AND ACCELERATORS

Incubators support the development of early-stage businesses by providing low-cost office space, and in some cases, research facilities. They can be a lifeline for entrepreneurs starting out and developing their business model.

Alongside facilities, accelerators typically provide startups with in-depth support as part of an intensive training/mentoring programme. In some cases, accelerators provide participants with a stipend. As a result, application processes are intensely competitive. In return, for the services offered, accelerators typically take around 4-7% equity in the companies they work with, although non-profit or public supported accelerators may take less, and in some cases nothing at all. As accelerators invest in the startups they support, they tend to only select high-potential startups.

"I had run businesses before, so am very conscious that the organic growth model restricts growth. In the tech sector, speed and scale is vital if you want to win. It's about raising the right amounts and the right circumstances."

CASE STUDY: MARCUS GINN **FOUNDER & CEO, EDOZO**

Marcus Ginn says Edozo started with a question: "How can we make property research simpler, faster, and more accurate? We have brought together experienced property professionals, entrepreneurs and technologists to create the fastest growing platform for commercial property maps and data."

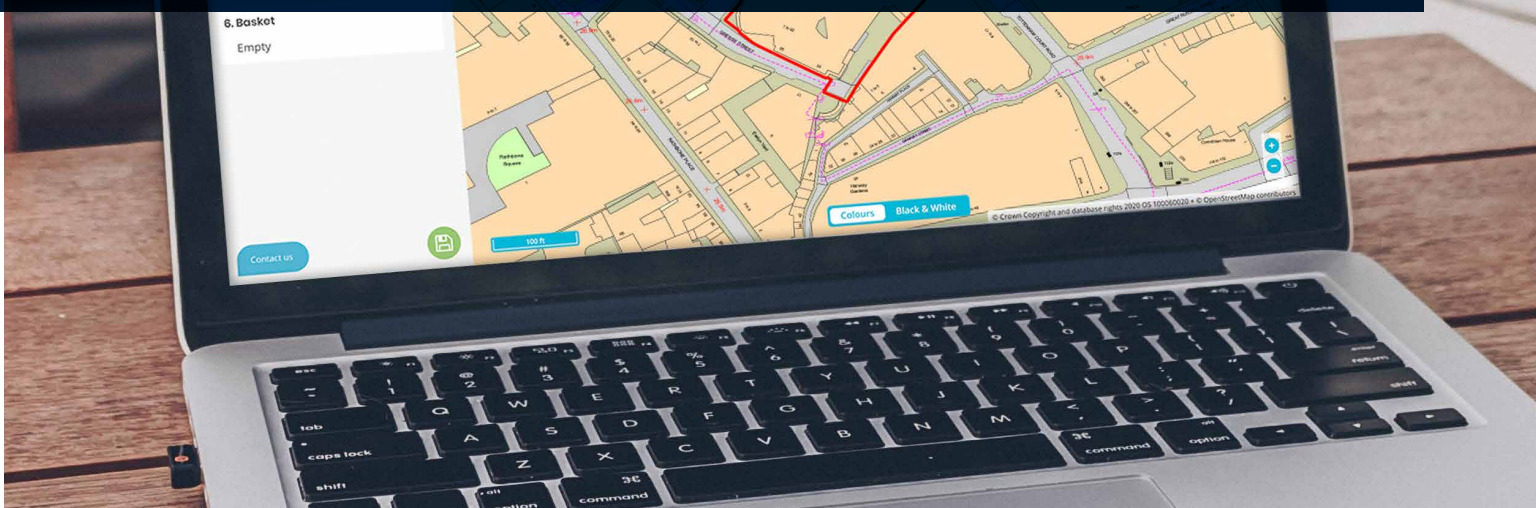
Ginn knew he wanted to do Series A, so was looking at a couple of different options. "I liked the accelerator style combined with corporate finance outreach," as it would help him "feel much better prepared for fundraising."

The Accelerator Network was commissioned to develop a VC investment readiness programme, which then saw White Horse Capital work with Edozo to secure funding for growth. "The most important thing for me about the accelerator programme was the three months process, rather than just taking the business plan and the fundraising strategy we had and throwing it at the market and hoping we find venture capital money that stuck," says Ginn.

"We took a step back and took time to write a really thorough business plan, challenge what a good five-year business plan and financial model looked like, and what the right fundraising strategy was." Ginn found the structure of weekly workshops, the range of advice, and being able to step back and really going into detail particularly useful.

Ginn was relaxed about giving away equity. "I had run businesses before, so am very conscious that the organic growth model restricts growth. In the tech sector, speed and scale is vital if you want to win. It's about raising the right amounts and the right circumstances."

Edozo's interim round closed in December 2019, and they are gearing up for a larger full Series A raise. They have 20 staff and are looking to double over the next two years, with more fundraising rounds planned as the business scales.



There are 205 incubators and 163 accelerators in the UK. Over the past decade, more than 5,000 startups have participated in accelerator programmes in the UK with numbers increasing significantly year-on-year.¹⁹ Silicon Valley accelerator Y-Combinator published a list of the most successful companies in the world to have gone through an accelerator. It includes Stripe, Airbnb, Dropbox, and Twitch.²⁰

Attendance at a prestigious accelerator can signal potential to external investors and accelerators typically work to help attendees with future investment opportunities. Research from Nesta, commissioned by BEIS, finds businesses that attend accelerator programmes have higher survival rates, employ more people, and raise more money.²¹ The study finds incubators and accelerators work by changing startup behaviour. By providing advice, access to networks, and coaching, entrepreneurs become more open to external

finance and are more likely to partner with external organisations.

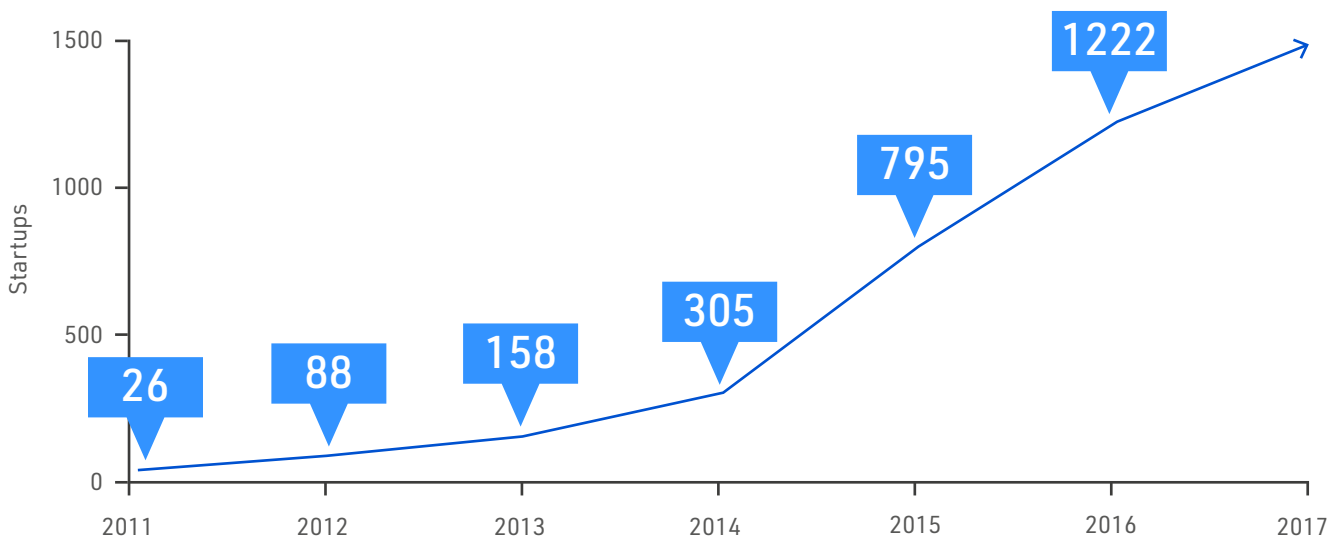
Accelerators may help close the female-founder equity gap as 38% of businesses attending accelerators in the UK have a female-founder. By contrast in 2018, just 17.9% of equity deals went to companies with at least one female founder. There are accelerators and incubators across the whole of the UK, but they tend to be disproportionately based in London. According to data from Beauhurst, 65% of accelerators can be found in London. However, the graduates of accelerator programmes tend to be more evenly distributed, suggesting that startups travel to attend the best programmes.²² Accelerated companies raise 44% more money and have 75% higher valuations than companies that haven't attended accelerators. However, this may be a result of selection bias. After all, accelerators only invite businesses to attend if they have high growth-potential.

POLICY IDEA: MAKE DATA SHARING OBLIGATORY FOR INCUBATORS AND ACCELERATORS RECEIVING PUBLIC FUNDING

Accelerators and incubators play an important role in the startup ecosystem. Attendance can be transformative and lead to faster growth. As a result, between £20m to £30m worth of public funding is invested annually in incubators and accelerators. Although it appears this investment is paying off, with accelerator attendance increasing, further scrutiny should be welcomed. In particular, more information about the types of accelerators that add the most value for participants should be available.

In the future, the government should make public support for accelerator programmes conditional on data sharing. This will allow us to identify the most successful programmes, and better understand why they work. It will also allow us to identify the schemes best at expanding access to entrepreneurship among disadvantaged or under-represented groups.

Startups attending accelerators



Source: Beauhurst.

19 Whorwood, H. (2018) Accelerating the UK. Beauhurst.

20 Y-Combinator (2019) Top Companies List.

21 Bone, J., Gonzalez-Uribe, J., Haley, C., & Lahr, H. (2019). The impact of business accelerators and incubators in the UK.

22 Whorwood, H. (2018) Accelerating the UK. Beauhurst.

CASE STUDY: ALEX PACKHAM FOUNDER & CEO, CONTENTCAL

ContentCal is a B2B SaaS business for companies looking to manage their content creation and content management.

Founder and CEO Alex Packham was introduced to Accelerator Academy through a referral and recommendation. He recommends other founders looking for an accelerator do their own online research, ask around their network, get on the phone, and go meet them.

Packham felt one of the big advantages of Accelerator Academy was their ability to match you to investors who are active, while the mentors they pair you with have made an investment within the last year. He thinks it's hard to build relationships when the investor event is at the end, whereas he had weekly sessions with his mentor over the three months, allowing him to build a proper relationship. He also valued the export talks and being in a room with ten other startup founders and sharing experiences.

Packham had previously raised through family, friends and angel investors. "You really consider in the early stages about giving away equity, how much to give away, controls you can still have in place, and that's always nerve-racking," he says. However, "if you want to build a big organisation, that's part and parcel so it's about getting your head around where you want to be and where you want to end up. Remove emotion as much as possible."

The accelerator taught Packham the mechanics of all the funding stages. "The structure of the programme facilitated a strong level of preparedness, having the right business plan prepared in advance enabled us to answer questions much faster, and doing due diligence prep in advance enabled us to get the deal relatively smoothly."

"Until you start going out and trying, you don't know", says Packham. It is hard work and you also have to be able to take it on the chin and be resilient."

Packham is ambitious to scale further. In the next few months, he is looking to expand his team of 25 people, and aims to grow 100-200% year-on-year.



“Since 2012 over 55,000 business ideas have been supported by the programme.”

START UP LOANS

If your business is just starting out, you might be able to access credit through Start Up Loans. You can borrow up to £25,000 from the Start Up Loans Company. The loans are government-backed, unsecured, and are bundled with 12 months of free mentoring from an experienced business advisor. Start Up Loans, which charge 6% annual interest, can be a cheap way to access credit if you lack a trading history or assets to put up for security.

The programme was started in 2012 to remove barriers to entrepreneurship. Startups can struggle to access credit, when they lack collateral and trading histories. Banks can be reluctant to provide low-value loans to small businesses as the associated due diligence costs can place pressure on margins. Start Up Loans are designed to fill this gap in the market and since 2012 over 55,000 business ideas have been supported by the programme.

The scheme was also designed to widen access to entrepreneurship to groups that are traditionally excluded due to lack of capital and access to investors. On this front, Start Up Loans have been successful. Just under half (40%)

of all loan recipients are female and over a fifth (22%) are from black, asian, or minority ethnic backgrounds.

A key concern for Start Up Loans are high default rates among borrowers. Around half of all loans end up defaulting.²³ Alongside the cost to the public purse, this can reduce the ability of borrowers to gain credit in the future. However, there will always be a trade-off between reducing default rates and providing credit to businesses underserved by the market. The best approach may be to ensure the mentoring offer is sufficient to avoid borrowers falling into distress.

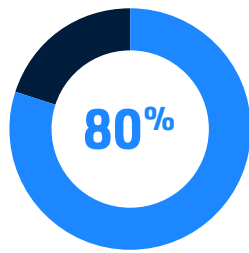
POLICY IDEA: IMPROVE THE MENTORING OFFER FOR START UP LOANS

New businesses can often struggle to access appropriate external advice. To correct this, recipients can receive up to 12 months mentoring support from an experienced business advisor. However, an evaluation of the programme found that not all businesses are offered mentoring support when they receive Start Up Loans. While not all founders will want mentoring, it is concerning that around one-fifth of recipients were not offered any support.

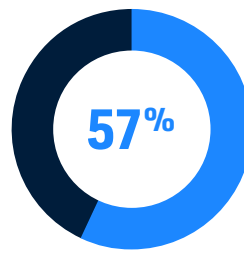
If the programme is renewed, there should be an extended focus on advice and support. The programme's evaluation found high numbers of discouraged borrowers among participants. Surveys of Start Up Loan receivers found 16% had “wanted to apply for external business finance in the last 12 months but did not do so”. This is almost twice as high as the general business population.²⁴ The Start Up Loans company should consider offering additional financial advice towards the loan's completion in order to address the high rate of discouraged borrowers.

²³ SQW & BMG Research (2019) Evaluation of Start Up Loans: Year 3 Report. British Business Bank.

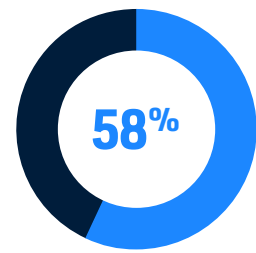
²⁴ Ibid.



80% of angels invest as part of a syndicate.



57% of business angels are based in London and the South East.



58% invest outside their home region.

Source: British Business Bank & UK Business Angels Association.

ANGEL INVESTMENT

Angel investment can be an attractive option for early or seed-stage businesses. Business angels invest their own wealth into early-stage businesses in return for equity. Alongside financial support, angel investors can help your business with advice and sales leads. Often entrepreneurs themselves, angels can help founders tweak their business model, open doors to new clients, and assist in later fundraisings.

The average angel investment is €180,000 in exchange for a stake of between 10% to 25%, but angels can invest both smaller or larger amounts.²⁵ According to the British Business Bank, over 600 business angels made more than 2,500 equity investments in 2016-17. However, the vast majority (80%) invest as part of a syndicate, where a group pools their money together.²⁶

There's a common misconception that angels only invest locally. In fact, 58% invest outside their home region and nearly a fifth (22%) invest outside the UK. However, as some angels prefer to spend time working directly with founders, proximity can be an advantage. Over half (57%) of business angels are based in London and the South East. Furthermore, 63% of non-London based angels invest in London.²⁷

Social entrepreneurs are likely to see angels as a key source of investment. One in four angels invests in a business with a broader social objective.²⁸

Finding the right angel can be a drawn-out process. Founders should ensure their business plans are relevant to the angel. Key factors affecting the decision to invest for angels includes potential to grow and scale (89%) and the experience and skills of the entrepreneur (93%). Tax relief is important to business angels. Almost nine out of ten angels have used EIS or SEIS and 80% of investments made by angels are made using the reliefs.²⁹

A survey of business angels finds most expect high returns from their investments, with angels expecting four of ten investments to return between one and five times the initial investment, two out of ten investments expected to return between six and ten times the initial investment, and one out of ten investment expected to generate a ten times return.³⁰

25 Haley, C., Van Blitterswijk, D., and Febvre, J. (2019) Paths to Scale: Finance lessons from European entrepreneurs. Nesta.

26 British Business Bank (2018) UK Business Angels Market.

27 Ibid.

28 Ibid.

29 Ibid.

30 Wright, M., Hart, M., & Fu, K. (2015). A nation of angels: Assessing the impact of angel investing across the UK. Enterprise Research Centre.

CASE STUDY: RANDA BENNETT CO-FOUNDER, VEELoop

VeeLoop is a safe online payment approval service for kids and teenagers. The child creates a basket online and uses VeeLoop to send it to their parent/guardian to vet and pay. It currently has five employees.

"We found out about angel investing when we first started researching and testing the business idea. Angel investors seemed to be recommended very strongly as the best route for early-stage companies," says Bennett.

"We've met several angels through pitching at angel networks, such as Oion (University of Oxford), Surrey University's S100, and Henley Business School's angel network and we had good interest from them," says Bennett. However, these didn't lead to deals.

"We got a six-figure angel investment from one high-net-worth angel investor. We were personally introduced to him by someone he trusted, who's a serial entrepreneur himself and had built a very strong network over the years. We had one meeting with this investor that lasted an hour and a half and he transferred the money within a week of meeting us," says Bennett.

Bennett found it "exceptionally difficult" finding the right angel, as they are "protected by several gatekeepers. When we were starting out prior to gaining traction we couldn't get through to pitch to any of the angel networks. We had straight 'no's', even though we had built the product and had a few hundred users. It's only when we had the traction of several thousand users that we were able to get through the gatekeepers and actually meet investors."

As well as offering advice and support, Bennett knows her angel investor will help when they need to raise further funding through his network of high-net-worth individuals. This is particularly useful given how time-consuming fundraising is.

Bennett found that "there are different breeds of investors who invest in very different ways, and what one group does doesn't always apply to the other. We realised that

there is this circle of high-net-worth angels that we've just started to tap into after three years of trying. Both myself and my co-founder are immigrants to the UK so we had to build every contact we have and gain trust over the years. We are only now starting to get the right introductions."

Bennett has changed the fundraising strategy. "Rather than raising a round and the struggle that comes with closing it, we're now raising a rolling round which means we are continuously raising and increasing our valuation based on the progress we are making. This means we still have to dedicate time to raising but we are finding this more effective than spending 3-6 months just fundraising and not growing the business," she says.

POLICY IDEA: STREAMLINE ADVANCE ASSURANCE FOR EIS AND SEIS TO UNLOCK MORE INVESTMENT IN HIGH-GROWTH STARTUPS

The Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) are targeted tax reliefs designed to promote equity investment into SMEs. They provide investors with relief from Capital Gains Tax and Income Tax if they invest risk capital. Investors also benefit from generous loss relief.

The tax breaks are powerful: in the 2017/2018 tax year, 3,920 SMEs raised £1.9bn in investment under EIS, alongside 2,320 SMEs raising £182m under SEIS. A Deloitte/Business Angels Association report found three-quarters (74%) of business angels believed the reliefs were a key factor in their decision to invest, and over half (58%) say they would have invested less or not at all, if the reliefs were not on offer.³¹ The reliefs play an important role in stimulating innovation, with HMRC research finding that three-quarters (74%) of investees had sought investment at least in part to start their business or to develop a new product or service.³²

In order to comply with EU State Aid Rules and prevent abuse, complex tax legislation has emerged. As a result, investors will not typically invest without Advanced Assurance from HMRC that the investment will qualify for the relief. HMRC aims to process each application within 15 days and 70% of applications are processed within 10 days. However, delays of six to eight weeks are common. For startups seeking investment through the scheme that are approaching the end of their funding runway, this can cause cashflow issues and force them to delay hiring new staff.

In order to clear the backlog and deter 'speculative applications', HMRC only reviews applications where investors are named. Some entrepreneurs warn this creates a 'Catch 22 scenario'.³³ Investors are unlikely to commit time to meet SMEs if there is a risk the investment will not qualify for the relief. The previous system, which allowed applicants to apply for Advanced Assurance before identifying an investor should be reinstated.

The long waits could be better tolerated by SMEs if there was clear communication from HMRC on the application's progress. Furthermore, HMRC should provide SMEs with clear feedback if an application for Advanced Assurance is rejected.

A number of measures could reduce delays and ensure more investment flows to innovative businesses. First, HMRC should work with investor organisations to produce pre-approved standard Articles of Association and Shareholders' Agreements. Second, businesses using the pre-approved documentation could be fast-tracked. Third, if there was a mechanism to make corrections for 'honest mistakes' post-investment, it may enable lower-risk applicants to outsource the process to accredited advisors without fearing loss of relief due to filing paperwork incorrectly.

31 Deloitte and UK Business Angels Association (2015) Taking the Pulse of the UK Angel Market.

32 The use and impact of venture capital schemes - February 2016 - HMRC Research Report 355.

33 The Entrepreneurs Network and Coadec (2019) The Startup Manifesto.



CASE STUDY: JOY FOSTER FOUNDER, TECHPIXIES

TechPixies is a multi-award-winning online learning platform that aims to help women across the UK upskill with tech.

After two pitching sessions in front of investors, Joy Foster secured £150,000 through seven investors in 2018 so she could grow her Oxford-based firm TechPixies – the majority through SEIS, and the rest through EIS.

If it hadn't been for the intervention of Adelpha, the angel investment advisory service run by Addie Pinkster, she might have walked away from the fledgling business altogether. "I'd been very ill with a serious chest infection earlier that year, partly because the business was not moving in the direction it needed to. In fact, it was on its knees. I was not my usual, optimistic self and, as a consequence, I felt I had no choice but to let people go. It was crushing," she says. "During those awful meetings, every single member of staff totally understood – but they all told me I had to save the business, one way or another."

Joy decided to explore ways to rebuild the business and to replace the labour-intensive face-to-face business model to a more efficient, digital one. "I was quite daunted by the amount of money I would have to borrow and repay with no guarantee of knowing whether I would ever be able to get where I wanted to be," she says.

"I happened to meet Addie at a Really Helpful Club event in Wimbledon and decided to ask Adelpha's advice. It was then that Addie said to me 'You are investable, your business is investable, you are fantastic, you can do this.' I realised I'd been going for so long on my own that I'd lost sight of why TechPixies was important and what potential it had. I also hadn't known that I needed someone to look at me through their eyes, with expertise and offer that level of reassurance. I knew I had to do it."

The following three months saw Adelpha help Joy nail her business plan, slides and pitches to investors. "They helped me develop a rock solid financial model," she says. "Once I had that in my hand and my pitch was rehearsed to the last detail, I knew I was ready." Joy pitched to two groups of investors, with Adelpha by her side.

One group in Joy's home town of Oxford and the other in London.

All her investors were female investors or female/male partnerships. Along with the investment comes an all-female board of advisers who are there to provide support and guidance every step of the way. "TechPixies is no longer considered a social enterprise in its purest sense, it is a commercially viable business with a good purpose, and that is just fine with me."

“SMEs in the UK are less likely to report bank loans as relevant to their business compared to SMEs in the US, France, or Germany.”

LOANS

Although the UK has seen a rise in the use of equity finance over the past decade, entrepreneurs are still most likely to turn to their bank first when looking to finance new investment.

Economic theory suggests there's a pecking order for investment. If a business cannot internally finance an investment, then they'll turn to debt and if unsuccessful, eventually to equity. Data from the British Business Bank suggests this is still how most businesses approach external finance. Credit cards and bank overdrafts are the most popular forms of external finance, used by 23% and 19% of SMEs respectively.³⁴ Shifting to long-term financing, bank loans and commercial mortgages, are used by 8% of all SMEs. Since 2012, application rates for new loans have almost halved from 2.9% to 1.5%.³⁵ Bank of England data suggest SME loans are still relatively affordable with an effective interest rate of 3.68%.³⁶

SMEs in the UK are less likely to report bank loans as relevant to their business compared to SMEs in the US, France, or Germany. Furthermore, they are less likely to report access to finance as the most important problem facing their business.

The relative unimportance of bank loans in the UK may be a result of reduced access to government loan guarantees. The UK has the second lowest level of government backed loan guarantees as a proportion of GDP in the OECD. This may be changing as the British Business Bank has expanded its long-running Enterprise Finance Guarantee (EFG). The scheme provides lenders with a 75% guarantee against the outstanding facility balance, de-risking the loan from the perspective of the lender and potentially turning a 'no' into a 'yes'. In order to benefit from an EFG, a startup must approach one of over 40 approved lenders. EFGs are not offered by default, but if a business has insufficient assets to

secure the loan against it, and is either under two years or over ten years old, the lender may take advantage of the EFG.

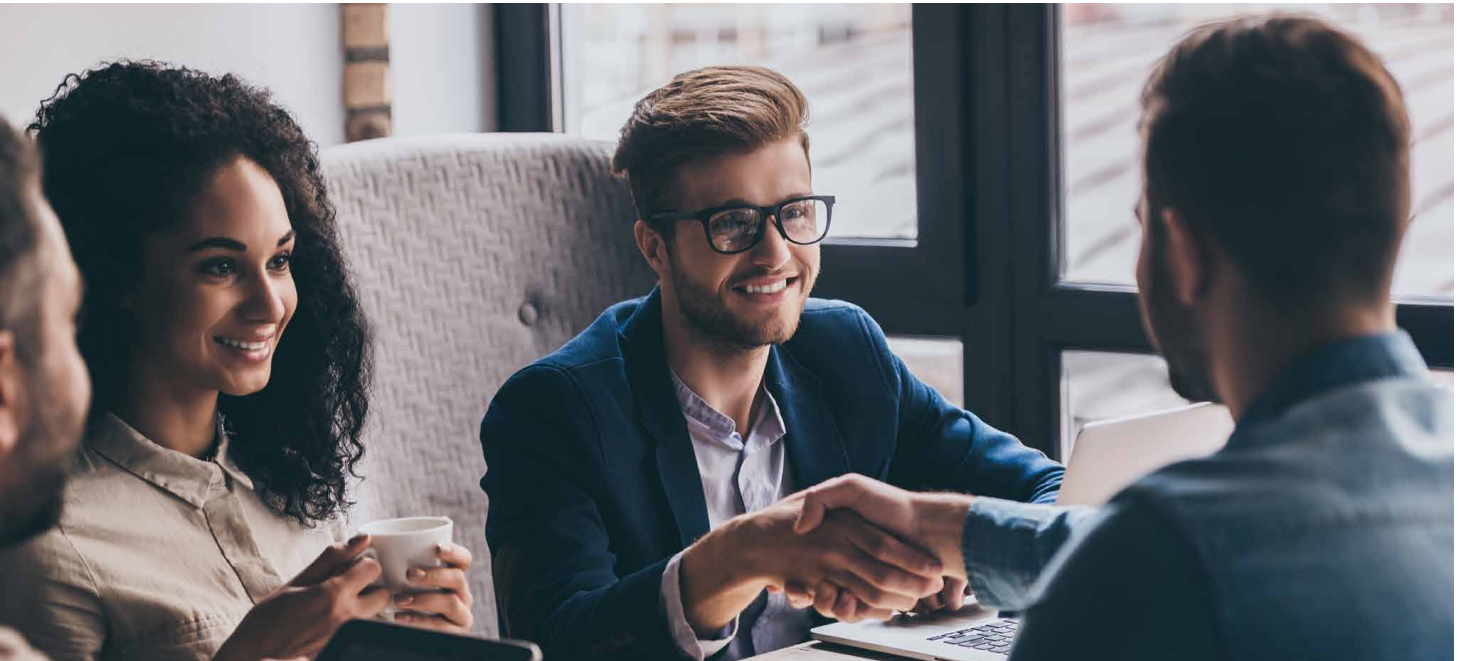
When looking for finance, SMEs are most likely to go directly to their main bank without researching other options or seeking out advice. However, according to the British Business Bank 'savvy entrepreneurs' who are most likely to have run a business in the past, are slightly more likely to seek out external advice. The lack of awareness of different options among SMEs and reliance on their main bank may explain why some borrowers are discouraged. They may be more likely to use external finance, if they knew about alternative options where they have a better chance of succeeding, such as P2P lending, specialist SME lenders, or challenger banks.

One remedy to this lack of 'shopping around' is the British Business Bank's referral scheme, where participating banks refer unsuccessful loan applicants to platforms that connect them to alternative finance options. If a business is unsuccessful, they may have better luck using a new specialist lender. Some specialist fintech lenders use different lending criteria and are able to offer loans to SMEs who lack trading histories. Open Banking reforms enable businesses to share their bank account data through a secure API creating further competition. However, many banks are not aware of the programme and some are sceptical.

³⁴ British Business Bank (2019) Small Business Finance Markets 2019/2020.

³⁵ Ibid.

³⁶ Ibid.



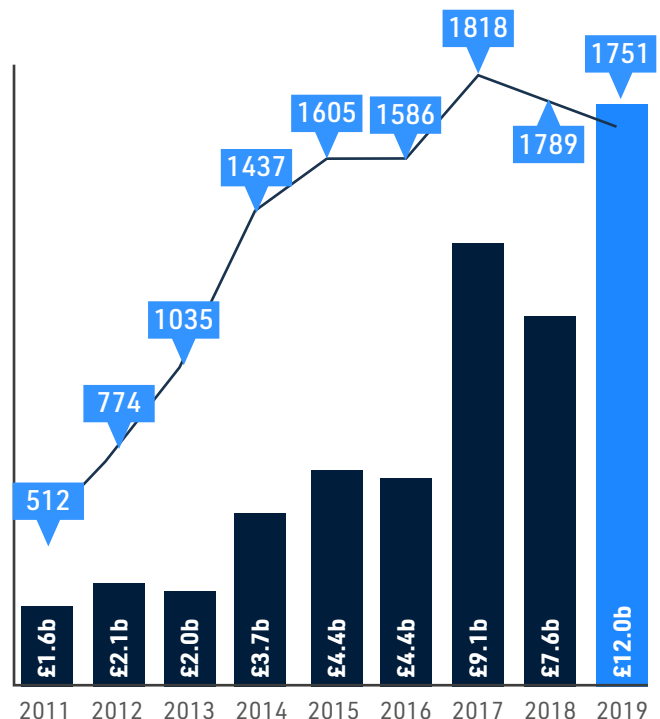
VENTURE CAPITAL

If your business relies on intellectual property or uncertain technology, then access to debt financing may be limited. Raising funds by selling equity to venture capitalists could be the solution for your external financing needs.

The past decade has seen rapid growth in the use of equity investment. In 2019, there were more than three times as many deals taking place as in 2011. At the same time, the total amount invested has increased almost tenfold from £1.6bn to £12bn.³⁷ Growth has been particularly pronounced at the growth and venture stage, and slower at the seed stage, with the number of seed deals falling two years in a row.

Although the vast majority of SMEs will never use venture capital to raise funds, VC-backed businesses have an outsized impact on the economy. Kaplan and Lerner note that while only 1 in 600 new businesses in the US are backed by VCs, those businesses represent 10% of private sector employment and make up 50% of IPOs.³⁸ The outsized impact of VC-backed businesses may be a result of the type of businesses that apply for VC funding. Furthermore, due to the high due diligence and active management costs, VCs tend to only invest in businesses with high growth potential.

The UK has seen rapid growth in equity investment



Source: Beauhurst.

³⁷ Beauhurst (2020) The Deal: Equity Investment in the UK in 2019.

³⁸ Kaplan, S. and J. Lerner, (2010) "It Ain't Broke: The Past, Present, and Future of Venture Capital," Journal of Applied Corporate Finance 22 (2), 36-46.

CASE STUDY: RICHARD MABEY & PAVEL KOVALEVICH, CO-FOUNDERS, JURO

Co-founded by Richard Mabey & Pavel Kovalevich in 2016, and now with offices in London and Riga, Juro is an end-to-end contract collaboration platform. "With a helping hand from AI, Juro enables businesses to agree legal contracts faster and gain more visibility into their contractual data," explains Mabey. Headcount is 21 and set to double this year.

Juro's mission is to "make legal more human". They have now raised two rounds of VC funding and while there's pressure from them to grow further, it was always their ambition to scale.

Their first VC actually reached out to them on Twitter, "so it was a fairly random encounter!" But Point Nine Capital is based in Berlin and has a strong record in backing fast-growth SaaS businesses, including Typeform, Algolia, Zendesk and others, so they took it seriously. Their Series A lead was perhaps a more conventional route. Union Square Ventures was introduced to them by Paul Forster, who was a co-founder of Indeed and one of their early angel investors.

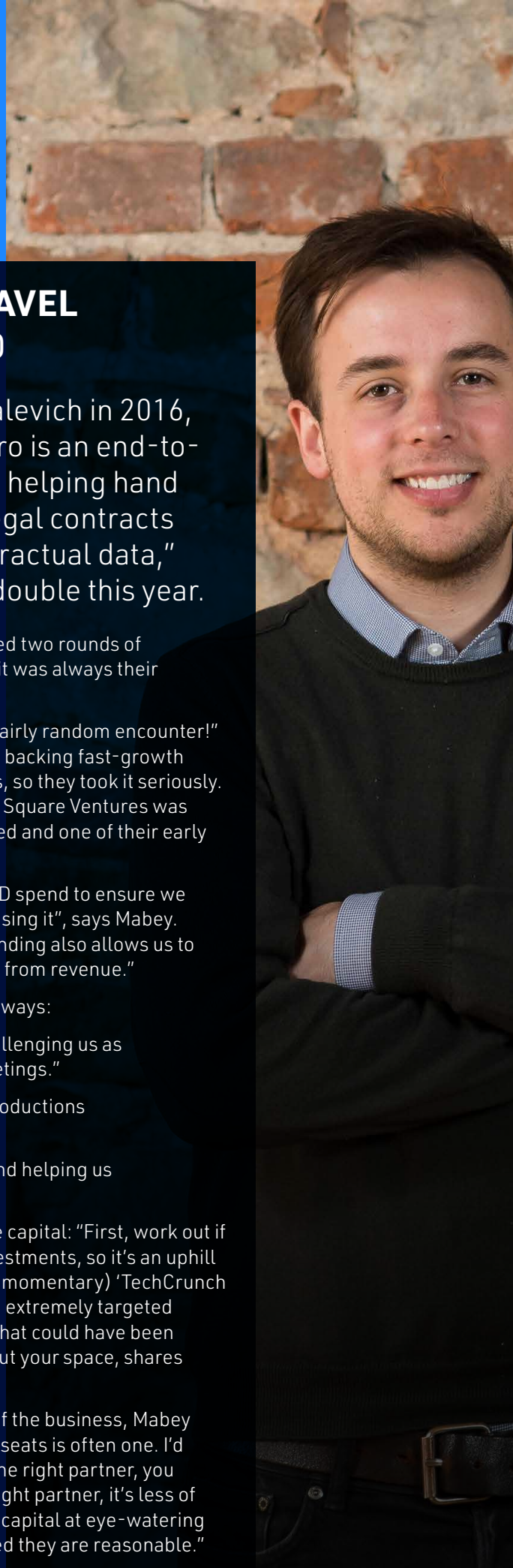
"Given our product ambition, we knew we would need a heavy R&D spend to ensure we really executed in the right way on the product before commercialising it", says Mabey. "Now that the market we are in is seeing significant growth, the funding also allows us to grow headcount far faster than we could if we were bootstrapping from revenue."

Mabey says Juro's VCs "have been great", and help them in 3 main ways:

1. Strategy: "Ensuring we keep a laser focus on execution and challenging us as founders of our strategic thinking, both in and out of board meetings."
2. Customer intros: "We have closed significant revenue from introductions made to prospects and fellow portfolio companies."
3. Exec hiring: "Getting their hands dirty in interview processes and helping us to focus on who to hire and when."

Mabey has advice for business owners considering raising venture capital: "First, work out if you actually need it. A VC might see 5,000 pitches a year for 10 investments, so it's an uphill battle. If it's not a battle you need to fight, don't pursue VC for the (momentary) 'TechCrunch glory' that follows. If you do raise from VCs, make sure you take an extremely targeted approach in who you speak to. Otherwise, that's just time wasted that could have been spent on your business. Find the VC partner who really knows about your space, shares your vision, and can add value over time."

When asked about the concern of losing control of the business, Mabey says there are trade-offs. "Giving up governance rights and board seats is often one. I'd come back to the point of finding the right partner. If they are not the right partner, you should be very concerned about giving up control; if they are the right partner, it's less of a concern. Stepping into their shoes, VCs deploy large amounts of capital at eye-watering valuations and so it's ok to accept governance protections, provided they are reasonable."





“We have closed significant revenue from introductions made to prospects and fellow portfolio companies.”

The outsized economic impact of VC investment has prompted policymakers across the world to encourage VC investment. In the UK, investors in Venture Capital Trusts (VCTs) investing in early-stage businesses benefit from generous tax relief, including 30% income tax relief for subscriptions in new VCT fund raisings, no tax on dividends, and no tax on capital gains on disposal.

VC investment typically comes in phases, with an expectation of value increases at each phase. A typical seed stage investment is €0.9m rising to €3.3m for early-stage and

€6.7m for late stage.³⁹ However, there is a trend toward larger deal sizes with the average deal size increasing by 57% in 2019 and a significant proportion of deals worth £10-50m.⁴⁰

On top of the funds invested, VC-backed firms benefit from external validation, access to contacts, and advice. VCs are often ex-entrepreneurs and can provide valuable input on how to run and scale a business. Contrary to popular belief, while a VC will often want a seat at the boardroom table, they do not want to micro-manage the business.

POLICY IDEA: UNLOCK ADDITIONAL INVESTMENT INTO VENTURE CAPITAL FROM DEFINED-CONTRIBUTION PENSIONS

Over the past decade, equity investment in UK startups and scale-ups has increased dramatically. Deal flow has tripled and the amount invested has increased more than sevenfold to £12bn in 2019.⁴¹ However, while we have seen rapid growth, the UK still underperforms relative to the US. According to PitchBook data, US VCs invested more than 10 times as much as UK VCs in 2017.⁴²

The difference may be explained by the impact of pension fund investment in venture capital. In the US, VCs are overwhelmingly (98%) funded by institutions such as pension funds, insurance companies, and endowments.⁴³ In particular, pension funds play a much larger role in the US. They contribute 65% of the capital in the US VC market and 18% in Europe, but just 12% in the UK.⁴⁴

By 2029 assets in defined-contribution pension schemes will exceed £1tn. If just 3% more of that funding went to venture capital, it would amount to a £30bn increase in equity investment available for startups. It could also provide benefits for savers in the UK. As an asset class, venture capital generated 61% larger returns than global equities.⁴⁵ Furthermore, venture capital returns are not closely correlated with equity markets. As a result, pension savers able to invest in traditional equities alongside venture capital are less exposed to the ups and downs of the stock market.

Increasing the funding available for venture capital may support growth outside of London and the South East. An analysis by the BEIS found that London, the South East, and East of England received 67% of equity deals between 2011 and 2017. An otherwise identical company was almost twice as likely to receive equity investment in London than in the North of England and Midlands.⁴⁶

There are two key barriers blocking pension fund investment into venture capital.

First, workplace pensions are subject to an annual 0.75% cap on fees. The measure is designed to protect savers, but conflicts with the VC model. Venture Capital funds typically charge a 2% management fee and take a 20% share of the uplift when the fund closes. Unlike traditional investments in stock markets, VCs invest smaller amounts and take a hands-on approach. Lifting the cap for investments in venture capital, provided investments in VC are capped at 15-20% would resolve the problem.

Second, pension regulations require assets under management to be valued regularly. VCs typically only book a change in value following an external event such as a funding round. Assets may still be valued semi-regularly, for example every six months, but they lack the liquidity of listed stocks. Pension funds may interpret this as insufficiently regular to comply with reporting regulations. The Treasury should work with the Department of Work and Pensions to develop clear rules on the valuation of illiquid assets.

39 Haley, C., Van Blitterswijk, D., and Febvre, J. (2019) Paths to Scale: Finance lessons from European entrepreneurs. Nesta.

40 Beauhurst (2020) The Deal: Equity Investment in the UK in 2019.

41 Ibid.

42 Meddings, S. (2019) The ones that got away. The Times.

43 British Business Bank (2018) £2.5bn British Patient Capital Programme launched to enable long-term investment in innovative companies across the UK.

44 British Business Bank (2019) Small Business Equity Tracker.

45 Oliver Wyman (2019) The Future Of Defined Contribution Pensions: Enabling Access To Venture Capital And Growth Equity. British Business Bank.

46 Wilson, N., Kacer, M., and Wright, M. (2019) Equity Finance and the UK Regions. Understanding Regional Variations in the Supply and Demand of Equity and Growth Finance for Business. BEIS Research Paper Number 2019/012.

POLICY IDEA: PROVIDE MORE LONG-TERM PATIENT CAPITAL THROUGH THE BRITISH BUSINESS BANK

One reason for the relatively low-levels of VC investment in regions outside London, the South-East, and the East of England is the relative 'thinness' in these regions. In thin markets, small numbers of investors and high-growth potential businesses have difficulty finding each other and working together. It can create a vicious cycle where too few early-stage investors discourage startups, which in turn can discourage new investors from entering the market.

To support the development of early-stage venture funds, the British Business Bank uses two funds: British Patient Capital (BPC) and Enterprise Capital Funds (ECF). In theory, ECF should fund smaller and less-established funds relative to BPC, but in practice there is significant overlap.

The government should encourage the British Business Bank to review how the two funds interact and investigate if they can be better directed towards solving market-failures. For instance, there may be a case for prioritising investments in regions under-served by venture capital or tying funding from the BPC to support for startup community building, such as training for emerging fund managers.



“You may be able to access credit through P2P lending even if you have been turned down by your bank.”

PEER-TO PEER LENDING

If your business is rejected for a bank loan, then you may have more luck using alternative peer-to-peer (P2P) lenders.

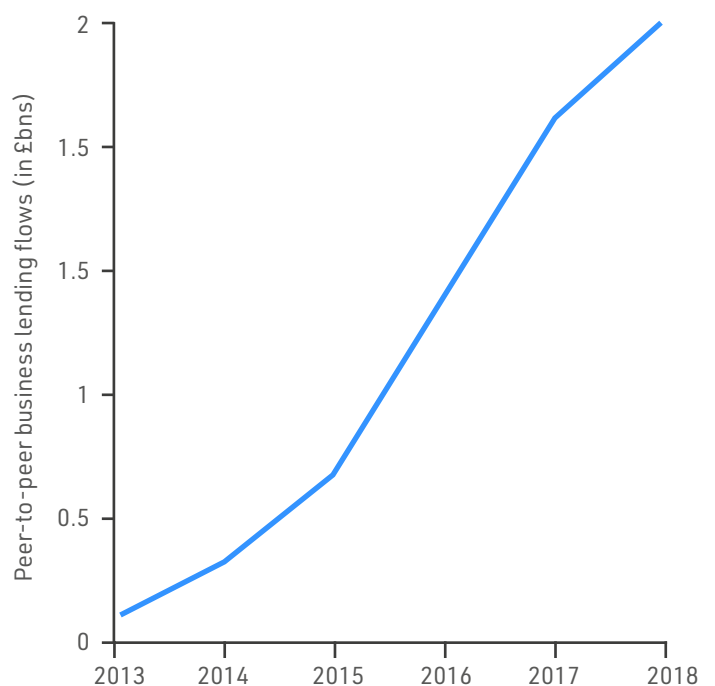
The key difference between P2P lending and traditional bank lending is that instead of borrowing from one bank, businesses borrow from thousands of investors connected by an online platform. P2P lending is fast growing, increasing tenfold to £2.33bn from 2013 to 2018.⁴⁷ The growth of the sector has been supported with products such as the Innovative Finance ISA, which allows individuals to invest in P2P loans with the tax-free ISA wrapper.

For businesses, there are three key advantages of using P2P instead of traditional lenders. First, P2P platforms can employ different lending criteria. Businesses may be able to access credit through P2P lending, even if they have been turned down by their bank. Second, P2P lenders tend to make faster lending decisions. In some cases, businesses can have a loan approved in a few hours. Third, by using technology and cutting out middlemen, P2P lenders can offer cheaper interest rates.

Unlike traditional bank lending, individual investors' capital is at risk. While in most cases, platforms spread investments over multiple loans and provide buffers, there is still a risk that investors could end up empty-handed. A survey of P2P investors found that nearly 40% had invested more than their annual income, exposing themselves to potentially large losses.⁴⁸

As a result, the sector has become more regulated with restrictions on marketing and a requirement that individuals cannot invest more than 10% of their investable assets into P2P loans unless they had received regulated financial advice.

Peer-to-peer lending has increased by more than tenfold



Source: British Business Bank.

⁴⁷ British Business Bank (2019) Small Business Finance Markets 2018/2019.

⁴⁸ Megaw, N. (2019) UK financial regulator clamps down on peer-to-peer investment. The Financial Times.

CASE STUDY: JACOB THUNDIL FOUNDER, COCOFINA

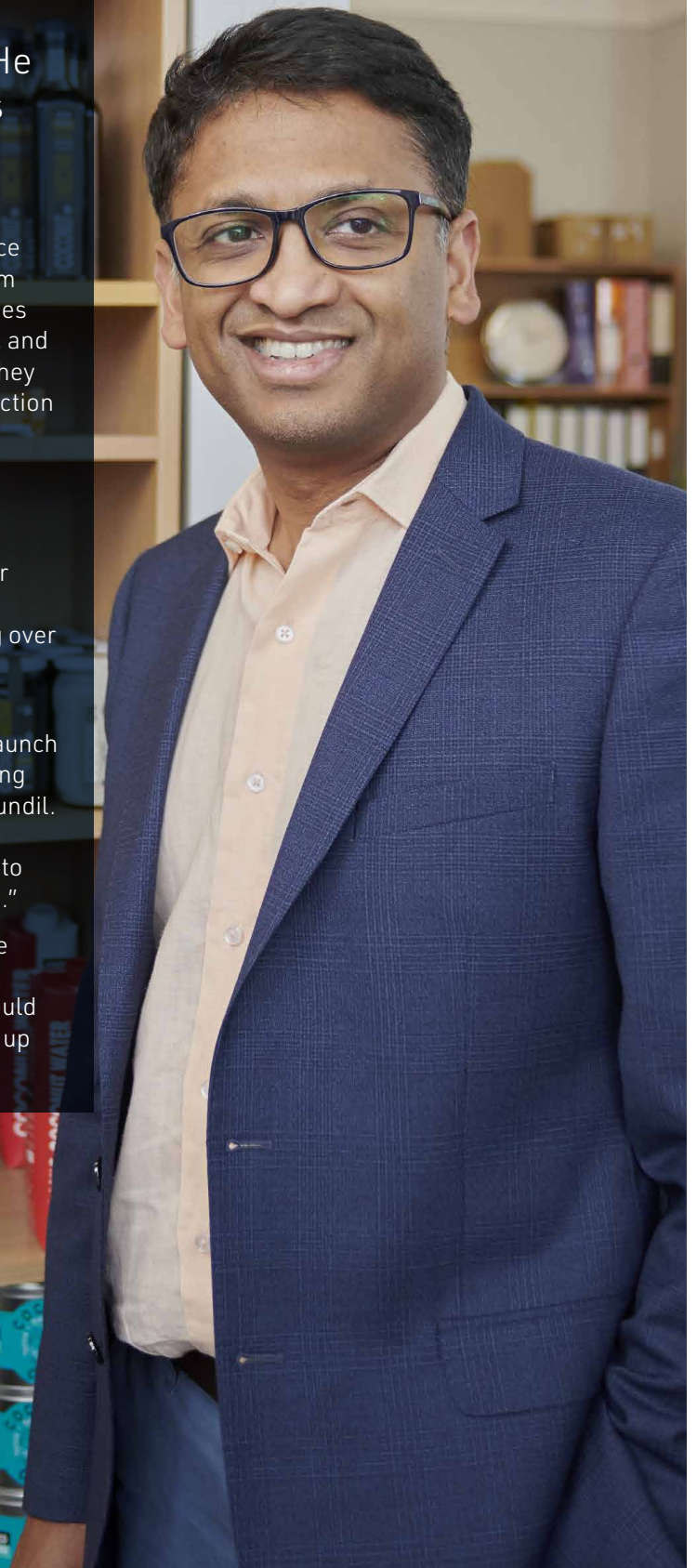
Fifteen-years-ago Jacob Thundil quit the safety of a job to start Cocofina, “way before coconuts were trendy.” He doesn’t claim to be a visionary, “I was just following my passion.”

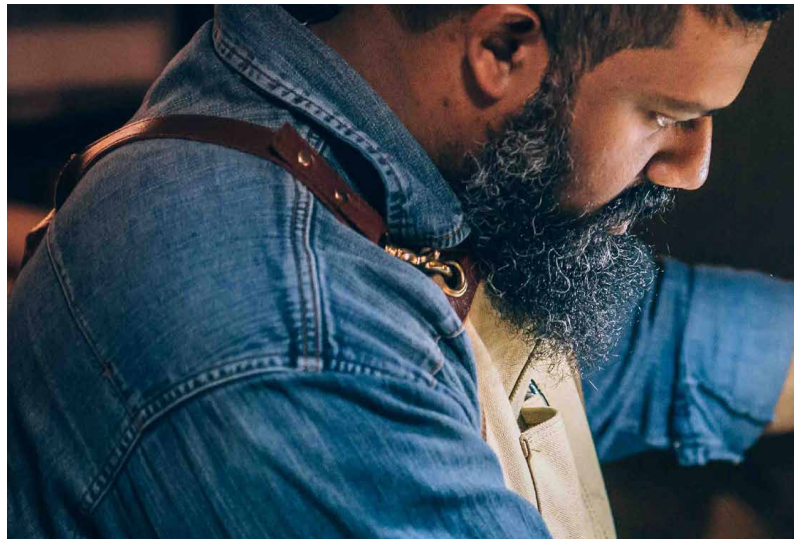
Cocofina produces staples like coconut oil and coconut water, but also more specialist products like a soya sauce alternative, and chocolate and hazelnut spread free from palm oil and refined sugar. They have production facilities in the Midlands and Wales, a warehouse facility in Kent, and a shop and office in London. There are six of them and they provide employment to more people indirectly in production and logistics.

Thundil hasn’t raised money through a bank. “It seems like a huge ask even for an established business such as ourselves. When we recently asked for a small bank guarantee to provide to HMRC our relationship manager discouraged us by saying that they needed to run credit checks etc. when they have the whole history of trading over the last 15 years right in front of them.”

Instead, Cocofina raised £100k through a peer-to-peer lender. They became aware of Money & Co from their launch marketing. “We ended up choosing them since everything seemed straight forward; we were not wrong,” says Thundil. “There was a more open conversation and feedback compared to a mainstream bank, which might not want to have a transparent dialogue on the qualification criteria.”

The process took 2 months, including the fund raise, the costs were comparable and they received favourable terms such as no early termination charges. Thundil would recommend it – “especially since you don’t need to give up equity.”





EQUITY CROWDFUNDING

Crowdfunding is not right for all businesses but in some cases it provides key advantages over traditional forms of investment. First, if you already have a dedicated user-base and brand-awareness, it can be quicker to raise through equity crowdfunding than traditional VC.⁴⁹

Second, the crowdfunding campaign is an opportunity to raise brand awareness and build thousands of fans. A successful raise may lead to positive media coverage, which in turn can make it easier to raise from traditional investors. Monzo was able to raise £20m through crowdfunding. As a result, it gained 36,000 investors who can act as ambassadors. Third, crowdfunding can help demonstrate market-fit. Investors may provide feedback on products and help the company address new needs.

Crowdfunding has drawbacks. First, businesses are required to disclose information to the public. This may not be an issue for a casual fast-food chain such as Chilango (who raised £3.4m in a single crowdfunding round), but if a business is at risk from copycats beating you to market, then it may not be appropriate. Second, failure can be public, potentially restricting a company's ability to raise investment in the future. Third, a successful crowdfunding campaign will typically require extensive preparation, promotion, and hard work.

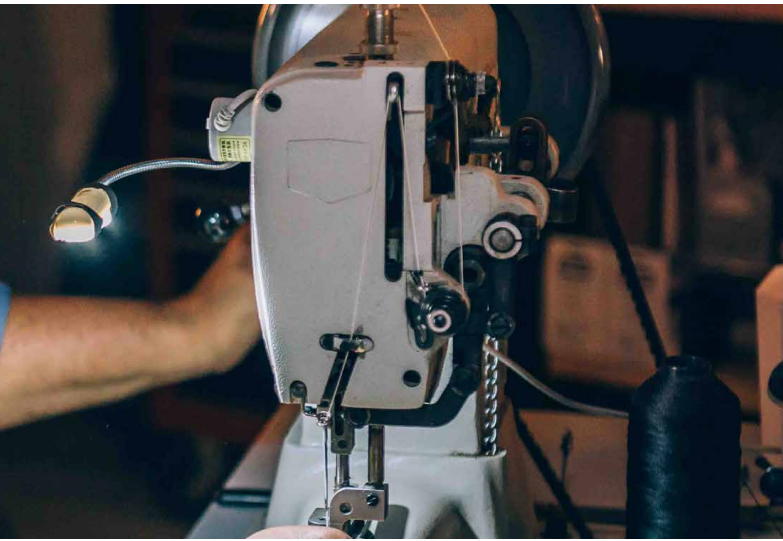
While it can deliver impressive results, crowdfunding should not be entered into lightly.

It is a fast-growing alternative to traditional venture capital. Through platforms, such as Crowdcube and Seedrs (the two largest in the UK), businesses can sell equity in small slices (in some cases for as little as £10 a share) to the general public. It is a relatively new phenomenon, with only 8 deals backed by equity crowdfunding in 2011. Close to 400 deals take place each year in the UK, with startups raising £525,000 on average per deal.⁵⁰ Crowdfunding tends to work best for businesses that are consumer-facing and with strong brands.

The UK is a world-leader in equity crowdfunding, in part due to a progressive attitude from regulators. The enabling approach from the Financial Conduct Authority (FCA), which prioritised informing investors, has allowed the sector to flourish. Furthermore, investments in equity crowdfunding can benefit from SEIS and EIS tax relief.

⁴⁹ Haley, C., Van Blitterswijk, D., and Febvre, J. (2019) Paths to Scale: Finance lessons from European entrepreneurs. Nesta.

⁵⁰ Scott, A. (2019) The UK crowd funding landscape in 2019 so far. Beauhurst.



EXPORT FINANCE

One in ten SMEs exports to an overseas market.⁵¹ Exporting can provide new opportunities for growth and make your business more resilient, reducing the risk of business failure. However, it is not without risk. In many cases, it requires travel to meet overseas clients and distributors, and substantial investment.

To support the government's objective to increase exports as a share of GDP to 35%, UK Export Finance (UKEF) works with 70 lenders and insurers to provide export finance. UKEF's mission is "to ensure that no viable UK export fails for lack of finance or insurance, while operating at no net cost to the taxpayer". Three-quarters of the businesses that UKEF works with are SMEs. There are two main types of export finance.

"Exporting can provide new opportunities for growth and make your business more resilient, reducing the risk of business failure."

First, insurance and guarantees protect exporters against the risk of non-payment by an overseas client. This is particularly valuable, for growing businesses expanding into new less-developed markets, where legal protections are not as strong

as in the UK. SMEs who contact UKEF will be put in touch with a finance manager, who will either work to develop bespoke export insurance policy or refer them to brokers. The policy will insure up to 95% of a contract's costs.

Second, UKEF provides loans and working capital solutions. For instance, if a business is having difficulty managing cash flow in response to new orders, they can seek a working capital solution or bond worth up to £5m. UKEF provides a guarantee worth up to 85% to commercial lenders providing export finance. In 2017, UKEF announced collaborations with five high-street banks to provide these loans.

⁵¹ Footnote: Department of Business, Energy and Industrial Strategy.

VENTURE DEBT

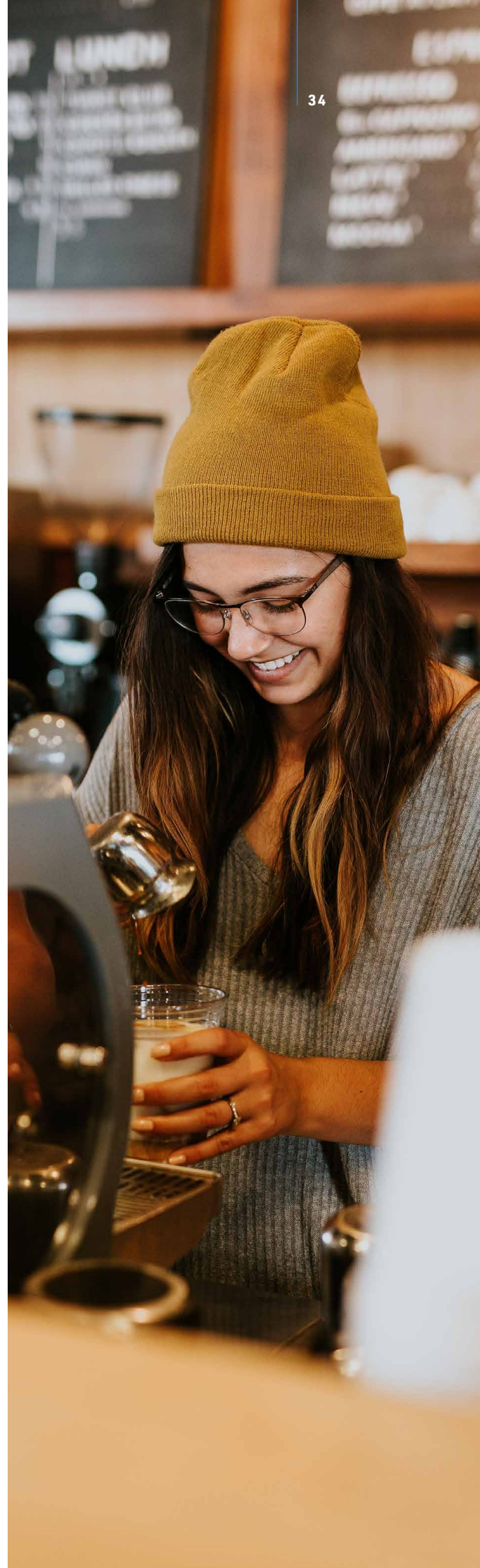
If you run a high-growth business and are raising funds through venture capital, venture debt can provide a bridge between funding rounds. If you need more funding to scale in advance of their next funding round, venture debt can buy time to meet certain milestones and demonstrate value to investors.

Venture debt differs from traditional loans in a number of ways. To adjust for the fact that companies in growth stage often run losses, the loans can be interest only for the initial period, followed by a balloon payment at the end of term. To compensate for the high risk of default, venture debt providers are typically given warrant that enable them to purchase shares in the company at an agreed strike price.

Venture debt is a less mature market in the UK compared with the US. The UK has 16 active venture debt fund managers compared to 109 in the US. According to a 2015 Barclays report, one in five US venture capital-backed businesses (including Facebook) used venture debt. By contrast, in the UK the figure is closer to one in ten.

There are two key advantages of venture debt. First, it's relatively quick to arrange compared to equity funding, with venture debt firms typically requiring less due diligence than VCs. Second, when structured correctly, venture debt tends to be cheaper and allows firms to minimise dilution of equity as they grow.⁵²

52 Gordan, P. (2012) Venture Debt: A Capital Idea for Startups. Kauffman Fellows.



CONCLUDING REMARKS

By helping small businesses manage cashflow, invest in better equipment, and expand into new markets, access to the right type of finance can be transformational. Yet many SMEs either struggle to access it or are deterred from seeking it, even though they are more likely to be successful than they think.

The best available data suggests almost one in ten (9.3%) of SMEs are discouraged borrowers, translating to an estimated £1.5bn in lost investment, less job creation, and slower economic growth.

While access to traditional bank loans has been limited since the global financial crisis, there are positive trends to celebrate too. Equity investment in startups has increased dramatically from £1.6bn to £12bn. We've seen the rise of alternative finance with peer-to-peer lending and equity crowdfunding

providing new opportunities for SMEs to finance growth. The diverse SME stories told throughout the report highlight the wide range of options available.

But more can be done. Modest reforms to the tax system, financial regulation, and grant funding will unlock new funding opportunities and ensure a lack of access to finance isn't a barrier to growth for any startup.

RECOMMENDATIONS



Experiment with lottery-style funding to channel more grant-funding to startups.



Simplify and modernise the R&D Tax Credit by providing better feedback for applications and expanding the score of activities that qualify as R&D.



Make data sharing obligatory for incubators and accelerators receiving public funding.



Provide more long-term patient capital through the British Business Bank.



Improve the mentoring offer for Start Up Loans by providing additional mentoring when businesses finish paying their loans.



Streamline the Advanced Assurance process for EIS and SEIS to unlock more investment in high-growth startups.



Unlock additional investment into venture capital from defined-contribution pensions by reforming the fee cap and clarifying rules on the valuation of illiquid assets.

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EnterpriseTrust

About The Enterprise Trust

It was launched in 2011 by Richard Harpin, the entrepreneur behind the UK's leading home repairs and improvements business HomeServe, now a FTSE 250 company valued at more than £4bn. The charity aims to create an impact and leave a legacy by helping individuals from all backgrounds to realise their potential as independent wealth generators. In 2020 the charity launched a research arm to extend its reach and provide important insight, new thinking and evidence-based problem-solving around the key issues affecting the UK's small business community.



About The Entrepreneurs Network

The Entrepreneurs Network is a think tank for Britain's most ambitious entrepreneurs. It supports entrepreneurs by:

- Producing cutting-edge research into the best policies to support entrepreneurship;
- Campaigning for policy changes that will help entrepreneurship flourish;
- Hosting regular events to bridge the gap between entrepreneurs and policymakers;
- Updating entrepreneurs on how policy changes will impact their business;
- Making the case in the media for entrepreneurs' contributions to society.

As the Secretariat of the APPG for Entrepreneurship, which was set up to encourage, support and promote entrepreneurship and to engage with entrepreneurs; it ensures that Parliament is kept up to date on what is needed to create and sustain the most favourable conditions for entrepreneurship.

Go up and never stop

A glowing blue neon sign is set against a black background. The sign features the text "Go up and never stop" in a cursive, handwritten style. Below the text is a long, straight arrow pointing to the right, also made of glowing blue neon. The entire sign has a bright, vibrant blue glow.



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