Rowlands Growth
Capital Review

Institute of Physics submission to a
Department for Business, Innovation and
Skills review

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17 July 2009
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Rowlands Growth Capital Review
Zone 190
Department of Business, Innovation and Skills
1 Victoria Street
London SW1H OET

IOP Institute of Physics

Dear Sir

Rowlands Growth Capital Review

The Institute of Physics is a scientific membership organisation devoted to increasing the understanding and application of physics. It has an extensive worldwide membership and is a leading communicator of physics with all audiences from specialists through government to the general public. Its publishing company, IOP Publishing, is a world leader in scientific publishing and the electronic dissemination of physics.

This submission was prepared in consultation with the Institute’s Business and Innovation Board and Small Business Forum.

The Institute welcomes the opportunity to respond to the BIS consultation: Rowlands Growth Capital Review. The attached annex highlights key issues of concern to the Institute.

If you need any further information on the points raised, please do not hesitate to contact me.

Yours faithfully,

John Brindley
Director, Membership and Business
1) Is there a failure in the supply of long term finance to support the growth of SMEs? Does the suitability of different types of finance vary for different categories of business growth? Please state your definition of SME in your answer.

There is currently an acute shortage of funds accessible to smaller science-based businesses seeking investment, something that is likely to have serious and long-term repercussions in the UK economy. Smaller science-based companies play a key role in the innovation economy bringing science knowledge and disruptive technologies to the market through the exploitation of the domestic research strength.

The precise definition of SME in this context is perhaps not the main issue, instead the stage of growth and the sectors in which the companies work are important factors to consider when gauging the levels of investment. Science-based businesses often require several years between the initial development of a product to sales and eventually profit-making, as such it is long-term, high-level investment that is essential for the success of these businesses. The recession, combined with its effect on the banking system has created a perfect storm for the finances of smaller science-based businesses and support is needed.

2) If there is a failure, what is its scale and nature and which type of SMEs does it affect?

The overall reduction in venture capital (VC) investment has been well characterised: the OECD has reported a drop of 60% in total US VC money in the past year and a recent NESTA review suggested that the amount of VC investment across the board in the UK has plummeted over the same period, particularly new investment in early-stage companies. This decline has been compounded by banks reducing their lending to higher-risk small companies and in some cases, withdrawing existing investment (smaller businesses will typically be the first cuts made by banks and investors as the economy tightens). One particular issue to be addressed is that the onset of the economic problems has left many SMEs burdened with loans which they cannot repay without growth capital and VC investment.

The effects of this drop-off may not be uniform across different sectors: science-based businesses start from a lower level of investment availability and so will be adversely affected. The longer term structural problems which were identified by the Engineering Technology Board (etb) in their SET and the City report have meant that over the past few years, science-based businesses have struggled to obtain the long-term, early stage investment they require. This is primarily due to low levels of engagement by larger VC funds and City Institutions, in contrast to the situation in

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1 Policy Responses to the Economic Crisis: Investing in Innovation for Long-Term growth, OECD, June 2009
2 Reshaping the UK Economy: The role of public investment in financing growth, NESTA June 2009
3 SET and the City, etb, 2006
the United States where investment from such funds drives the high technology sector. The etb highlighted issues relating to risk, and the lack of understanding of the prospects for science-based companies as key factors behind this lack of engagement and we would agree with this assessment. Any public VC fund should have a greater understanding of science and science-based business.

The current difficulties should not be regarded as a wholly new problem and the current Review is an opportunity to address both the immediate crisis and also the broader problems. The recent drop may be the final nail in the coffin for commercial early-stage investment in science-based SMEs and addressing this longer-term market failure must be a part of the solution.

3) What is the level of demand amongst SMEs for additional long term capital for growth, as opposed to shorter term, flexible and available capital? If there is demand, what are acceptable costs of raising such capital and the appropriate return i.e. is dilution of equity acceptable? What evidence would you cite in support of this view?

No comment.

4) If a financing gap exists, is there a range in the size of investments or risk:return profile of investment that is particularly difficult to obtain; at what level is this and why?

The small business ‘equity gap’ is well characterised as being a serious problem for companies seeking investments of the order of £250 000 to £1 000 0004 to move from product development to the market. The gap is in part due to the structures of investment funds and their process of investment: the relatively small amounts of money don’t benefit from the economies of scale associated with larger investments, and the high-risk natures of the investment (which should be balanced by the high returns) often deter larger investment firms driven by pension funds and city institutions. VC funds instead move up the investment ladder to larger, later-stage, lower-risk investments. These problems remain, however, the recession and its effect on VC and banking investments have extended this ‘gap’ to include almost all investment in small science-based companies.

Additional sources of capital funding, such as bank lending have also been affected with the the economic climate has resulted in this avenue either no longer being available, or becoming significantly harder to achieve. Anecdotal evidence suggests that a third source of funds, business angels, is also much reduced as individual investors become reluctant to make long-term commitments to capital-intensive high-tech proposals where it can be several years before an exit is possible.

5) Is there a difference across regions in the ease with which SMEs can access the appropriate type of long term growth capital, and if so why?

The Regional Development Agencies (RDAs) are a major cause of the variation in access to VC across the UK, both in terms of direct funding and also leveraging of private money. This variation in availability and scales of funds can have a dramatic effect on the future successes of companies in each region. For example, it might be that equally viable companies in different RDAs with identical potential for success can be offered different levels of engagement and investment: in terms of leveraging

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private VC investment, a previous investment from an RDA is more persuasive than a letter of commendation.

The varying provisions of VC funding in different regions perhaps reflect the future plans and the interests of the RDAs more than they reflect the current needs of businesses in the region. Additionally, it may be that the target-driven cultures of the RDAs do not allow them to fully extend into the long-term investments needed for true early-stage support for science-based businesses. The Technology Strategy Board (TSB) already works in partnership with the RDAs in some areas, and it should be given greater oversight of their VC activities to promote engagement with science-based businesses.

6) Is private capital available and willing to be invested in SME Growth Capital asset class? What would the minimum return expectations be?

No Comment

7) Should Government seek to intervene in this market, and if so, what are the policy options and measures for doing so?

The main objectives of any intervention should be to ‘free up’ the existing market, and also to address the structural problems that have prevented science-based companies from accessing investment. This should be accomplished through engaging with private funds and RDA funds, steering them towards areas they have perhaps otherwise been averse to.

This will require a change in mentality within some of these existing funds to promote investment in early-stage science-based businesses: it is this reluctance that is the over-arching issue and addressing this must be at the heart of any intervention. There is a danger that introducing liquidity to the system without addressing these structural problems will result in a system that will not meet the objective of promoting science-based businesses in the long term. The TSB, with its experience in dealing with science-based businesses, is ideally placed to offer guidance in this area and should take on a leadership role in any new fund.

An additional area that should be considered is the apparent contradictions and conflicts between government intentions and European state aid legislation that has caused some confusion within the existing public/private structures, such as the RDA-driven funds. The requirement that quantities of public money cannot go directly to profit-making companies, for example, has caused problems for RDAs seeking to partner with private investors to support existing companies. It is not clear how this situation can be rectified.

A further option might be to explore the encouragement of inter-company investment and support. It has previously been suggested that larger pharmaceutical companies could have a role to play in this area within the UK\(^5\) but there has been limited interest, and the current economic climate may prove increasingly prohibitive for such activity. This is certainly not the case in other countries, for example, in the US, Microsoft operates the BizSpark\(^6\) programme investing in smaller companies as a means to provide itself with raw materials and corporate partners. It may be that there are regulatory or tax issues which are inhibiting inter-company investment, and this avenue would perhaps benefit from further investigation.

\(^5\) www.hm-treasury.gov.uk/cooksey_review_index.htm
\(^6\) www.microsoft.com/bizspark/
8) What would be the appropriate approach to the delivery of any Government interventions for meeting this objective?

The ‘fund of funds’ structure proposed by the Prime Minister\(^7\) has advantages in terms of ‘ready-made’ staffing and infrastructure, however for the fund to meet its objectives, it must focus on areas where a difference can and needs to be made, such as smaller science-based businesses. For any intervention to succeed it is essential that the objectives for the funds are clear and well defined, and that those running the fund have a strong understanding of science-based businesses. The TSB is well placed to take a leadership role in this area.

In terms of measuring success, it should be remembered that investing in early stage science-based companies has an impact across the economy, and so success of any programme shouldn’t be measured only by the success of individual companies, but in terms of take-up of the investment itself.

Any intervention must be made with reference to other machinery tasked with supporting any promoting science-based SMEs, and while perhaps slightly outside the remit of this review, attention should be paid to the problems experienced by larger SMEs for whom flotation on the stock market may no longer be an option. The broader innovation agenda, and especially the innovative procurement exercises should be refocused on the economic downturn to support science-based businesses through pre-procurement strategies and particularly the Small Business Research Initiative (SBRI) programme which has shown the potential to be a significant source of support for such industries.

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