Financing a private sector recovery

Institute of Physics submission to a HM Treasury and Department of Business, Innovation and Skills consultation.

A full list of the Institute’s responses and submissions to consultations can be found at www.iop.org

23 September 2010
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Business Finance Green Paper
Fourth Floor
Department for Business, Innovation & Skills
1 Victoria Street
London
SW1H 0ET

IOP Institute of Physics

Dear Sir/Madam

Financing a private sector recovery

The Institute of Physics is a scientific charity devoted to increasing the practice, understanding and application of physics. It has a worldwide membership of over 37,000 and is a leading communicator of physics-related science to all audiences, from specialists through to government and the general public. Its publishing company, IOP Publishing, is a world leader in scientific publishing and the electronic dissemination of physics.

The Institute welcomes the opportunity to respond to the HM Treasury and Department of Business, Innovation and Skills consultation, ‘Financing a private sector recovery’. The attached annex highlights key issues of concern to the Institute.

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

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

Yours faithfully,

Professor Marshall Stoneham FRS CPhys FInstP
President Elect
The Institute of Physics

John Brindley
Director, Membership and Business
The Institute of Physics
Financing a private sector recovery

1. Do you agree with the evidence base as set out in this paper? Are there any additional issues that should be considered?

There is currently an acute shortage of funds accessible to smaller science-based businesses seeking investment, a situation that may have serious and long-term repercussions for the UK economy.

Smaller science-based companies play a key role in the innovation economy bringing science knowledge and disruptive technologies to the market. These businesses often require several years between the initial development of a product, to sales and eventually profit-making. As such, it is long-term 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 additional, focused support is needed.

The overall reduction in venture capital (VC) investment has been well characterised, for example, the OECD has reported a recent drop of 60% in total US VC money\(^1\) 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\(^2\). This decline has been compounded by banks reducing their lending to higher-risk small companies and, in some cases, withdrawing existing investment.

However, it should be noted that the effects of this drop-off are not uniform across different sectors: science-based businesses start from a lower level of investment availability and so will be more adversely affected. Longer-term structural problems identified by the then Engineering Technology Board (ETB) in its SET and the City report\(^3\) 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 partly due to low levels of engagement by larger VC funds and City Institutions, and is in contrast to the situation in the United States where investment from such funds drives the high technology sectors. The report also highlighted issues relating to risk, and the lack of understanding of, and confidence in, science-based companies as key factors behind this lack of engagement and we would agree with this assessment.

As such, the recent difficulties should not be regarded as a wholly new problem and the forthcoming white paper is an opportunity to address both the immediate crisis and also the broader problems with the financing of science-based businesses.

One additional factor which may affect the fortunes of science-based businesses is possible reductions in the level of public spending on science and research.

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2. *Reshaping the UK Economy: The role of public investment in financing growth*, NESTA June 2009
3. *SET and the City*, ETB, 2006
Research groups can be a primary market for goods and services of smaller science-based business, with businesses often working closely with the researchers to produce new and innovative products which can ultimately be further developed for use in high technology industry both in the UK and abroad. Cuts to this lead market will have a significant effect on some businesses.

To put these issues in context, science-based innovative businesses will have an important role to play in growing the UK economy. Physics-based businesses contribute 6.4% of UK GVA and employ more than a million people\(^4\), a significant proportion in small- and medium-sized enterprises (SMEs). These businesses have the potential to be key drivers of growth in a re-balanced economy and it is surprising that this strength is not referenced or reflected in the green paper.

2. Do you think greater certainty over future tax and regulation would have a significant impact on current demand for or supply of business finance?

No comment.

3. Are there any regulatory obligations that may disproportionately deter SMEs from listing on exchange-regulated markets such as AIM and Plus Quoted? What can be done to address this?

No comment.

4. Are there any additional barriers to corporates (of any size) accessing equity markets and how could these be addressed?

The small business ‘equity gap’ is well characterised as being a serious problem for companies seeking investments of the order of £250 000 to £2 500 000 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 (risks 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. In addition to these established conditions, however, the recession and its effects on VC and banking investments has extended this ‘gap’ to include almost all investment in small science-based companies.

There is a role for public money in closing this gap. 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, working with them to steer them towards areas to which they would currently be averse. This will require a change in mentality within some of these existing funds, making them more confident in investing 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. Without addressing this lack of confidence on the part of investors, there is a danger that introducing liquidity to the system will result in an

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\(^4\) Physics and the UK Economy, The Institute of Physics, 2007
intervention that will not meet the objective of promoting science-based businesses in the long term.

To enable this, the driving feature of these interventions should be to allow businesses and investors the freedom to invest as they see appropriate, rather than there being top-down control over investment decisions. The Technology Strategy Board (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, along with businesses, in any intervention. There is a need to understand the particular risk-reward profile of science-based businesses, which has not necessarily been apparent in previous government actions, and to focus on building confidence between business and investors.

5. How can Government ensure that the best small businesses in all parts of the UK are visible to publicly backed venture capital funds?

This may be difficult to achieve with limited means and reduced regional structures; however, we would recommend a role for the new TSB ‘Connect’ website. A part of the disparities observed currently may be the early-stage investment issue and it may be that such smaller, innovative businesses do not attract interest regardless of their location in the UK.

Should Government intervention to address the equity gap focus on the best firms regardless of geography, or seek explicitly to address regional economic disparities?

The Regional Development Agencies (RDAs) were a major factor in 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. We would recommend that efforts to address broader regional disparities should not be linked with investment in high-technology business – investment decisions should instead be made on market-driven criteria.

The Government would be particularly interested in views on regional stock exchanges.

No comment.

6. How can publicly-backed equity schemes and the Growth Capital Fund make more use of private capital in future? How could the scale and reach of publicly backed funds be improved? Are there any gaps within the portfolio?

There is an argument for ‘streams’ of public funding, focusing perhaps on major challenges such as energy, healthcare, security. However, such streaming should be driven by the strengths of the SME base in the UK, rather than just focusing on servicing larger companies or specific strengths within the research base. Alongside these streams, there should also be opportunities for investment in other areas, to account for the often unpredictable and fast moving developments in science.

Does the potential model for the Growth Capital Fund meet the objective of filling a gap in the availability of funding for growth companies?
The model has advantages in terms of ‘ready-made’ staffing and infrastructure of private investment groups, however for the fund to meet the desired 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, through development of knowledge capital and job creation, and so success of any programme shouldn’t be measured only by the success of individual companies, but also in terms of take-up of the investment itself.

**Are there ways in which the potential model could be developed to improve its appeal to investors or its ability to make a material contribution to the funding of growth companies?**

One 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 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*\(^5\) 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.

**7. How could more high-net-worth individuals be encouraged to become Business Angels and participate in larger deals through syndicates? Are there specific issues impeding business angel activity that the Government should address, such as investor readiness or the structure of publicly-backed venture capital funds?**

Any intervention must be made with reference to other machinery tasked with supporting and promoting science-based SMEs. Innovative procurement exercises should be refocused to support science-based businesses, particularly the Small Business Research Initiative (SBRI) programme which has shown the potential to be a significant source of support for such industries. Involvement in such programmes, and ultimately the opportunity to bid for procurement contracts, can engender confidence in the business in the eyes of angels and other investors.

With regard to enabling several individuals to become joint Business Angels, a formalised method to broker syndicates could be investigated. Such arrangements could be focused on creating syndicates containing balances of skills and experience suited to particular business sectors.

**8. How can eligible businesses help themselves to become ‘investment ready’ for equity finance? Where should this be done by private sector, market-led solutions? What role is there for Government in supporting this, and should**

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\(^5\) [http://www.bizspark.com](http://www.bizspark.com)
intensive Government support be focussed on businesses high growth potential?

As noted previously, public procurement strategies have the potential to be a significant factor in presenting science-based businesses as ‘investment ready’. The knowledge that a procurement contact is an option for smaller innovative business would mitigate some of the risk associated with investing in companies. We would recommend that, even in times of budgetary restraint, that such programmes are supported across government departments.

9. How effective are current tax incentives for equity investment in small businesses, such as the Enterprise Investment Scheme or Venture Capital Trusts?

No comment.

10. Are there any steps that industry, financial institutions or government could take to promote access to debt capital markets for a greater number of UK businesses?

No comment.

11. What more could be done to promote greater competition in the provision of business finance?

No comment.

12. What other actions could be taken to help businesses (of all sizes) access a wider range of different finance options?

It should be noted that many actions that could be of benefit to science-based SMEs do not need to be novel, but can instead build on or develop existing processes that can improve market penetration or open up new markets. Further, the outcomes of these programmes shouldn't be measured in solely in terms of rapid growth or increase turnover, but also as the action of the investment itself in extending the lifetime of a small company, and the jobs it creates. SMEs represent the vital and fertile seed-bed from where tomorrow’s large corporations will emerge, but they also can continue to provide new jobs as well as long-term security of existing ones.
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