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22 September 2017

Financing Growth in Innovative Firms
HM Treasury (2 Orange)
1 Horse Guards Road
London
SW1A 2HQ

financing.growth@hmtreasury.gsi.gov.uk

Dear Sirs,

**Financing growth in innovative firms**

I am writing on behalf of ShareSoc (the UK Individual Shareholders Society) who represent the views of individual investors across the United Kingdom.

We welcome the opportunity to respond to the government's consultation on financing growth in innovative firms.

**Introductory comments:**

1. Individual shareholders are the archetypal long-term investors. They tend to invest for retirement, to fund care in later life and to pass on wealth to future generations, as well as for growth and income.
2. The FCA Asset Management Market Study has highlighted the high fees (and other charges and forms of remuneration) and the anti-competitive behaviour that occurs in this industry. This effectively increases the cost of capital for innovative growth firms and reduces the supply of investor capital. Walker and Kay also identified this issue. Sorting out the excesses of the financial services industry is proving difficult.
3. The banks' behaviour since the 2007/08 financial crisis, when they squeezed their customers, withdrew facilities and demanded much higher and more onerous terms has resulted in a huge decrease in the confidence of their customers in the banks[1]. This will take a very long-term to correct.
4. The taxation treatment of debt versus equity is not equal. Interest on debt is tax-deductible, whereas payments of dividends to shareholders come out of after-tax profits.
5. As a consequence of points 3 and 4 above, many companies take on debt and have a very short-term orientation.
6. Capital gains tax has been subject to a huge number of changes over the past 40 years. Government should not expect a long-term perspective from companies and their owners if it keeps changing the rules. In future, Government should only make changes infrequently and only when they are clearly necessary. Presently, there are two main issues:
    a. Capital gains tax taper relief over 10 years should be reintroduced. The idea that the longer you hold an investment the lower the tax rate will be a huge factor in increasing

[1] For example RBS GRG and Lloyds treatment of SMEs.

long-term thinking. The removal of this taper relief (and prior to that, its reduction from 10 years to a shorter period) has been instrumental in stimulating a short-term focus and culture.

b. Capital gains tax for individuals is assessed on each individual investment[2], so if an investor wishes to take a profit which is then reinvested in another growth or innovative company, the investors' capital is reduced by a taxation charge. The investor has not at this stage had access to his capital to spend it, so it is illogical to tax him or her at this time. This contrasts with investments held in an investment trust, where no capital gains tax is levied on gains within the trust; only on amounts that are taken out of the trust.

7. We, in Britain, need to create a culture of long-term thinking. Patient capital is needed. We need a culture whereby we think about accumulating wealth gradually. The get rich quick culture of the early 2000s served to create a large social imbalance.
8. The UK markets give lower valuations than US markets to growth companies and innovative companies. This creates an opportunity for US based companies to acquire UK companies cheaply. This is one reason why the UK has failed to produce large successful innovative growth companies on the same scale as the US.
9. We can see no representative of individual investors on your steering committee. This is a shameful major omission, and is evidence of the way in which individual investors continue to be ignored and underestimated. Direct individual investors make up 12% of the UK stock market, and with indirect individual investors via funds represent 30%. Your steering committee comprises representatives of fund managers rather than underlying asset owners. We note also that successful 'hands-on' entrepreneurs such as Luke Johnson and James Dyson are not represented on your panel.
10. The current VCT tax reliefs are justified by creating incentives to invest. There is no evidence of excessive profits for individuals investing in VCTs. The VCT regime seems to be working satisfactorily. Government should resist the temptations to significantly change something which is working. (Minor changes to stop abuse should be implemented, but only after careful consideration of other consequences.)

**Our qualifications in credentials for making this response**

1. ShareSoc has 4,000 members and is a recognised representative group for the interests of individual shareholders within the UK.
2. Our members invest in shares, including those of AIM growth companies
3. Our members also invest via VCTs. We have particular concerns about the governance of these vehicles and the fees paid to fund managers.
4. It is probable that many of our investors also have EIS and other investments and that many are business angels. However, we do not collect data at present about their interests in these areas, so we cannot confirm this point.

***Responses to specific questions***

**Q1 Do a material number of firms in the UK lack the long-term finance that they need to scale up successfully?**

Yes, this is our belief. However, data supporting this claim is patchy, and there needs to be more research into the availability of finance to the following segments in particular:

- Stage of development (start-up, early stage development, growth etc),

[2] We note that losses can be offset against gains. But, this is incidental to the argument above.

- Age of company
- Type of business: manufacturing, services, and within these basic categories the business sector (Technology, hospitality, aerospace, consumer goods etc)

There is comment in the consultation document on the availability of finance by geographical region. However, a more robust analysis of the shortage of finance is needed if meaningful conclusions are to be drawn and targeted steps are to be taken to address the issue.

Table 6.C is deeply flawed. Everyone including HMT now seems to accept this.

**Q2 Where is the gap most acute by type of firm, stage of firm development and amount invested?**

The most acute gap, in our view, is defined by the amount of money required. Companies looking to raise capital below £10m are effectively restricted to personal finance (bank loan etc secured against the homes and or other assets of the directors). There are firms such as Connection Capital (CC) which act as syndicators of finance from relatively sophisticated retail investors. CC typically provides finance up to about £15m and in many cases, invests alongside other investment organisations. Individuals investing through Connection Capital usually invest in units of £25,000. They can buy as many units as they want. CC manages the investment for them. It needs to be remembered that businesses like CC are essentially 'selling' esoteric investment opportunities. A key component of the 'sell' is the time horizon for exiting the investment (usually 3-5 years) and the prospect of an attractive ROI over that period. Whether this really constitutes 'patient capital' is debatable.

The shortage of funds for businesses needing less that £10m probably also defines the type of firm: i.e. micro businesses which have recently started up and which have only a limited commercial track record.

Other factors which are likely to make it difficult for these types of company to raise finance are:

- The business expertise of the founders; they may be very good technically but if they have little business expertise they will struggle to find backers. They may, for example, not even be capable of producing a very credible business plan.
- The market for the product or service they are offering; for innovative products, it may be difficult to assess market potential – particularly in areas where technology is developing very fast and novel ideas and concepts can easily be overtaken by alternative approaches e.g. the demise of excellent software systems such as VisiCalc and Wordcraft in the face of the more comprehensive suite of programmes contained within Microsoft Office.
- Barriers to entry and the ability to shut out competitors or maintain a strong competitive lead long enough for the business to grow and become established.
- The ability of the business organisation to grow; too often the original founders want to retain hands-on control of the business. They are reluctant to bring in professional management expertise and, when they do, it results in conflict and management distraction.

There are, in short, many factors other than simple issue of access to finance which determine whether a business is going to grow and be successful.

**Q3 Have we correctly identified the UK's current strengths in patient capital?**

We do not wish to comment on this question.

**Q4 In what order would you prioritise the UK's weaknesses in patient capital?**

Patient capital often comes with too many strings attached. The founders of the business are often asked to pay a high price in terms of ceding control of their businesses to outside investors. This may be in return for an injection of external capital with is relatively small and which, in many cases, is inadequate to meet the medium term financial needs of the business. In our experience (investing through vehicles such as Connection Capital) there are, within two to three years, calls for further rounds of investment usually with massive dilution to the initial investment.

**Q5 What are the main root causes holding back effective deployment of and demand for patient capital?**

The lack of funds targeting small to mid-size technology businesses is a major problem.

The lack of analyst reports and public information on such companies when they are listed is also a problem which will be exacerbated by recent regulatory changes.

We are not convinced that allowing a "dual share class" structure would encourage entrepreneurs or assist with fund raising. Most wise investors hate such arrangements. Certainly, raising more capital via equity placings can be a problem for company management where founders or major investors wish to retain control. This to a large extent comes back to the problem of protecting minority investors – founders don't wish to become minority investors at present because of UK legal difficulties that can then arise.

As outlined in the consultation document, investment via fund managers and other similar investment channels often comes with too many strings attached for the founders. They are often required to give up control of the business (part with over 50% of the shares) and the oversight from the investor is often intrusive and unhelpful in terms of constant reporting on and pressure to meet short term targets.

**Q6 What are the main barriers holding back effective supply of patient capital by major investors?**

We believe that the primary problem is a lack of knowledge and of experience of growth sectors, combined with a lack of any technology or science background. The UK educational system tends to produce fund managers without technical or scientific qualifications. Fund managers tend to invest in what they understand hence the focus on more established sectors of the economy than software or biotechnology.

The UK markets give lower valuations than US markets to growth companies and innovative companies. This creates an opportunity for US based companies to buy UK companies cheaply. This is one reason why the UK has failed to produce large successful innovative growth companies on the same scale as the US.

Some of the research presented in the consultation document is fundamentally misleading. Box 2B states that, based on research by the ERC, of the 239,649 firms started up in 1998 only 11% survived 15 years. However, it is not clear what survival means here. Does it mean that they survived as independent entities or that only 11% managed to avoid going bust? There is a world of difference between the two. For example, there is nothing wrong with a firm being bought out by a larger business at some stage of its development (perhaps after 5-10 years). The new owner may well play the role of an excellent 'patient capital' investor, providing access to significant long-term funding plus a wide range of other benefits, including of access to markets, deeper and better resourced R&D and professional management skills. As the chief executive of the German car company Daimler recently commented, "Our venture capital is our 10% margin" (FT; Lex column; 14.9.2017).

The consultation document focuses too heavily on investment by traditional asset manages and investment funds. Large established businesses are potential investors in small innovative firms. As outlined above, investment through this route is likely to be much more successful that other more traditional forms of investment which provide money and little more. All too often the medium-term aim of the traditional investment houses is to sell the investee on at a large profit. These investors have limited understanding of the business in which they are investing and their aims are not aligned with those of the managers of the investee company. It would be more helpful to encourage larger businesses to invest in small firms in sectors which are of interest to them.

The consultation document does refer to businesses which have a venture capital unit. This does not appear to be commonplace. It is something that ought to be encouraged for reasons stated above.

**Q7 Which programmes (investment programmes, tax reliefs and tax-incentivized investment schemes) have most effectively supported the investment of patient capital to date?**

1. Tax of PE partners investments as capital not income. see https://www.bvca.co.uk/Portals/0/library/Files/StandardIndustryDocuments/PDF_1.pdf?ver=2013-06-14-112732-737
2. VCT
3. EIS

**Q8 Are there areas where the cost effectiveness of current tax reliefs could be improved, for example reducing lower risk 'capital preservation' investments in the venture capital schemes?**

We think the tax relief on debt interest should be reviewed. This will obviously take some time and will require coordinated action with the US, G20, etc.

Current tax benefits of EIS and VCT have not created an oversupply of capital, so should be preserved and further developed.

2015 FA changes were radical and it will be several years to see the effect of these changes.

Care of the elderly is an area where relief could be targeted.

**Q9 Are there other ways the venture capital schemes could support investment in patient capital, in the context of State aid restrictions and evidence on cost effectiveness?**

We do not wish to comment on this question.

**Q10 When is it more appropriate for government to support patient capital through investment rather than through a tax relief?**

We believe that a range of reliefs and incentives is the best primary approach. This is a complex area requiring a complex solution, and it would be naïve to suggest that there is one simple panacea.

We believe that a CDC-style central investment unit could be highly beneficial for the development of smaller, high tech companies. Such a unit could operate on an "additionality" basis alongside the private sector, either pari passu or on a subordinated basis.

Some areas of government ought to be able to invest in businesses. For example, organisations such as GCHQ work at the 'cutting edge' of technology in certain highly specialised fields. Looking beyond the relatively limited domain of national security, some of this technology could have huge commercial potential. In many cases it would require further development for this potential to be realised.

Implementing this sort of system would not be easy but it would be worth exploring. Note that this idea could take us in the direction of some form of joint venture between the parties. JVs have patchy track record of success – primarily because neither party has control. However, the idea would bear closer examination.

**Q11 Is there an optimum minimum length of time of investment for entrepreneurs and investors to focus on the long-term growth of their company and, if so, what is it?**

This will differ for different companies in different sectors with different technologies. An ideal investment horizon is one or more economic cycles (7 years); however, to build a world beating technology is likely to take 10 to 20 years.

The length of time one either needs or wishes to hold an investment is very varied. Investors are generally happy to continue to hold an investment so long as necessary and so long as it is making progress.

Individual investors, who are often elderly, may not wish to hold investments past a certain age, even if business property relief is available. Corporate bodies, particularly quoted ones, will not have that difficulty, but they need to show consistent returns which often drive realisations. VCTs tend not to want to hold very large companies.

Investors' horizons tend to be shortened when Government changes the operating frameworks, or there is a perception that Government may change the rules. It is therefore critical that Government operates a stable framework and desists from tinkering with the tax regime and other regulations. It is helpful if Government states and restates regularly its position, but what is most important is its actions; as in this context actions speak louder than words.

**Q12 What other steps could government take to make current tax reliefs more efficient and effective, to provide the best support in line with their policy objectives?**

Quicker pre-approval reviews of prospective EIS/VCT investments by HMRC would be helpful. There seems to have been major delays in this area of late which may have caused investments not to happen.

**Q13 What scale of new investment should the government seek to unlock and over what timeframe?**

The focus should be on more stimulating institutional investment in "scale-ups" of middle sized companies. This is where the gap lies at present. We are not in a position to advise on scale.

**Q14 Should resources be focused on one intervention (e.g. a single fund of significant scale) or spread over a number of different programmes?**

Resources should span many different programmes. This is a complex issue requiring complex solutions. Any simplistic solution is likely to be gamed.

**Q15 When considering how to replace EIF investment if the EIF were no longer an investor in the UK, to what extent should the government seek to replicate the EIF's current activities in (a) venture capital and (b) private equity?**

The focus should be on free market solutions, supported by selective government intervention. Standalone government funded solutions tend to fail and, as the paper notes, have a patchy track record.

**Q16 Beyond replicating existing EIF investment if required, what areas should government focus on to increase investment in patient capital?**

The original 3i was a good model, Investors in Industry. Ideal areas of focus include technology, biotech, education, fintech.

**Q17 When considering how to support increased investment, should the government consider supporting one or more of the setup of a public-private partnership, a new incubated fund in the BBB to be sold in part or full to private investors once it has established a successful track record and a series of private sector fund of funds to invest in patient capital?**

We recommend a CDC style government fund to invest alongside the private sector.

**Q18 If desirable, what steps should government take to encourage investors to form a new public-private partnership to increase investment in patient capital?**

Simply assuming that civil servants will be able to re-skill as venture capitalists will not work. There needs to be a commercial unit within the relevant public-sector body which acts as a quasi-venture capital or even 'joint venture' operation. This needs to address not only matters of finance but also issues such as terms of the relationship, business planning, ownership of intellectual property rights and other assets and how the investment by the parties will be valued and recovered plus the split of gains following any sale of the business.

**Q19 What steps should the government take to support greater retail investment in listed patient capital vehicles?**

It is tempting to suggest that there is a great opportunity here for both retail investors and businesses looking for investment. However, investments in small unlisted businesses are illiquid (cannot be sold easily) and are often risky from a commercial point of view. It should also be noted that a minority holding in an unlisted business may be worth much less than the pro-rata value of the shares that are represented by the holding. There is plenty of scope for naïve, inexperienced or unsophisticated investors to lose all their money.

There ought to be channels through with retail investors can invest directly in unlisted growth companies. These channels need to be tightly controlled and regulated. Models for this exist already – such as that exemplified by Connection Capital. The existing models currently have deficiencies (charges and who is getting what out of the deal are not always entirely clear) but these could be addressed. Other issues to be considered are:

- You need to ensure that retail investors are properly represented and their views heard and listened to.
- We can see no representative of individual investors on your steering committee. This is shameful. That it is not untypical of the way in which individual investors continue to be poorly treated. Individual investors and 12% of the UK stock market, and via funds are beneficial owners of 30% of the UK stock market.
- Your steering committee seems to be packed with representatives of fund managers rather than asset owners. There are a good and representative number of successful entrepreneurs, but there may not be representatives of failed or steady performers.
- Capital gains tax taper relief over 10 years should be reintroduced. The idea that the longer you hold an investment the lower the tax rate will be a huge factor in increasing long-term thinking. The removal of this taper relief (And prior to this its reduction from 10 years to a shorter period) created a much more short-term focus. This problem now needs to be addressed.

- Government should consider expanding support for VCTs which have proved to be successful in attracting retail investors. Simplifying the regulations, making them less onerous, and commitments not to change them or tax reliefs retrospectively would help. Perhaps special encouragement for technology investments could be considered, or other "non-asset" based ones to encourage a more entrepreneurial high-tech sector would assist.

**Q20 Will focusing resources on increasing investment provide better value for money than changes to the tax environment?**

Both approaches should be adopted simultaneously. It is not realistic to assess the relative benefits in terms of value for money, since the effects of both can vary dramatically according to how they are implemented.

**Q21 Beyond measures already being considered to support more effective asset allocation decisions by DB pension funds across their portfolio of investments, what further steps should be taken to support investment by DB pension funds in patient capital?**

DB pensions should not be used as instruments of government policy. This notwithstanding, current pension rules have caused pension DB pension funds to de-risk to an unreasonable degree. A review is required in order to stimulate a return of the sector to a more balanced investment portfolio.

**Q22 How can individual DC pension savers be best supported to invest in illiquid assets such as patient capital?**

HMRC should allow transfer of VCT/EIS investments into DC pension funds with no CGT charge and such transfers should not count towards the £1m LTA. The £1m LTA should be increased to £1.8m. The AA allowance should be increased by the amount of VCT/EIS contributions made during the year.

There is a huge amount of patient capital looking for a place to invest, caused by the reduction of the LTA from £1.8 million in 2006 to £1 million now. It would be in all parties' interests to steer this towards innovative growth companies.

**Q23 Are there barriers to investment in patient capital for other investors that the government should look to remove?**

We do not wish to comment on this question.

**Q24 What steps should government take to support the next generation of high potential fund managers to develop their knowledge and skills and to raise their first or next fund?**

There needs to be greater emphasis on technical knowledge. It is crucial that fund managers understand the detail of the underlying technologies is that the companies are involved with and can converse with them knowledgeably about this. In too many cases, the emphasis has been on financial engineering which inevitably leads to short termism.

**Q25 What further steps, if any, should government take to increase investment into university spin-outs specifically?**

See comments under Q10 and Q18 above. A similar approach could be applied to university spin-outs. We suggest that there should be a central specialist body overseeing spin-outs (actual and potential) from higher education. It should not be done on a university by university basis.

**Q26 What further steps should be taken to increase investor capability in the public markets to invest effectively in firms requiring patient capital to grow to scale?**

There needs to be a sea change in the curriculum in schools. This would include but not be limited to:

1. Compound interest. How to calculate it and its impact on returns from investments and the impact of charges and fees.
2. Probability theory. Improved understanding of probability of different types of events and of conditional probability.
3. The difference between correlation and causation.
4. Diversification of portfolios.
5. Lognormal distributions and likely share price returns.

There ought to be channels through with retail investors can invest directly in unlisted growth companies. These channels need to be tightly controlled and regulated. Models for this exist already – such as that exemplified by Connection Capital. The existing models currently have deficiencies (charges and who is getting what out of the deal are not always entirely clear) but these could be addressed. Other issues to be considered are:

- It is very important that individual investors are properly represented and their view heard and listened to. This is not currently the case, and the output of the recent BEIS review falls short on this matter.

- Individual investors should be represented on your steering committee.

If you would like to discuss our response in more detail, we would be happy to attend a meeting.

Yours faithfully,

Cliff Weight
Director
ShareSoc