THE FUTURE OF GROWTH CAPITAL
REPORT

Deloitte. INNOVATE|FINANCE
AUGUST 2020
Deloitte

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Innovate Finance is the independent industry body that represents and advances the global FinTech community in the UK. Our mission is to accelerate the UK’s leading role in the financial services sector by directly supporting the next generation of technology-led innovators.

Innovate Finance’s membership ranges from seed stage startups and global financial institutions to investors, professional services firms, and global FinTech hubs. By bringing together and connecting the most forward-thinking participants in financial services, Innovate Finance is helping create a global financial services sector that is more transparent, more sustainable and more inclusive.

ScaleUp Institute

The ScaleUp Institute is a private sector-led, not-for-profit organisation focused on collaborating with policymakers, corporates, finance players, educators and government at a local and national level.

Our mission is to help the UK to become the best place in the world to grow a business as well as start one, and enable our existing high-growth businesses to scale up even further.

Scaleup businesses are defined as companies which have increased their turnover and/or employee numbers annually by more than 20 per cent over a three-year period. Nationally, the latest 2018 data from ONS showed that there are 33,860 of these businesses generating more than £1 trillion to the UK economy. The national number of scaleup companies has increased by more than one-third over the last five years. In parallel, we have a generation of scaling businesses who are growing at greater than five percent whose scaleup potential must be encouraged and fostered.

Our thanks to our partners, supporters and contributors to this document.

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Report designed and produced by ScaleUp Institute.
The Growth Capital Gap is not a new issue. It predates the two most recent economic shocks we have faced in the 2008-9 recession and the COVID-19 pandemic.

Many will be familiar with the struggles faced by promising, fast-growing companies seeking to access the capital they need to achieve their potential. In our own careers, which have focused on making finance better through innovation in financial services and ensuring this innovation flourishes with the right backing, we have seen first-hand how the issue has persisted. It has held too many innovative businesses back from achieving their true potential, and stymied wider economic growth as a result.

In May 2020, building on the work of our two institutions, we were asked to lead working groups, on behalf of the Business Action Council and the Recapitalisation Project, to look at finding strategic finance solutions in support of our entrepreneurs and their businesses in the medium to longer term, looking beyond the current crisis. We have since engaged our wide-ranging ecosystem of investors, banks, businesses, government and industry, who have a key interest in ensuring scale-up companies can rely on a redefined infrastructure for accessing growth capital.

As the ScaleUp Institute has evidenced these businesses are an important part of our economic makeup for many reasons. They are innovative, diverse and productive. They create high-quality jobs, they are internationally focused and they span an array of sectors. Providing them with access to growth capital would accelerate a bigger ecosystem of scale-up companies, creating more jobs, and more economic growth across the UK. We must seize the huge opportunity that the UK can gain by backing these companies.

Today’s challenge of fuelling a sustainable economic recovery, and with a new relationship with the EU on the horizon, means it is now the time to make bold moves to invest in tomorrow’s successful businesses through greater collaboration between the public and private sector.

The Future of Growth Capital’ report lays out a plan for how the UK can respond to Covid-19 and better back its scaling businesses - both the new and the established. We should build on what is already in place and expand or realign current efforts to help those same innovative businesses. It will require a coordinated effort to bring forward the changes we recommend, encompassed by a new national strategy, providing us with a blueprint for a growth legacy on which to build.

Furthermore, this strategy will enable us to accelerate the unlocking of institutional and corporate funding for those businesses and to build on a network of national development banks, with strengthened reach into local communities, that puts the British Business Bank and British Patient Capital at its centre. We are also calling for an expansion of Innovate UK’s role and scale to deliver, along with a more heightened focus on R&D by reassessing our deployment of the OECD’s Frascati Manual and the creation of a ‘Future Opportunity Fund’, to support emerging and socially inclusive areas of our economy.

As we look forward to the Comprehensive Spending Review, we hope this report can provide insight to policymakers on the current challenges and an outline of the opportunities for collaboration between the private and public sectors on the way forward.

We are truly grateful to everyone who has given their thoughts, insights and expertise to aid our research. Our thanks go in particular to the excellent team at Deloitte, led by Richard Kibble, for the resource, contribution and collaboration upon it.

We look forward to progressing the recommendations with government and private sector stakeholders. We see this report as a tool and a convening point to support the desire across industry and government to - together - build back better with a robust, national blueprint for growth. The private sector across finance and industry stands ready.

Colin Mayer, Peter Moores Professor of Management Studies, University of Oxford Said Business School
EXECUTIVE SUMMARY

Access to appropriate Growth Capital is the fuel to maintain a vibrant, innovative economy. It is one of the key foundations to building world-beating global companies and a dynamic economy that in every locality seizes opportunities and fosters jobs and sustainable growth for the long-term. It is a key enabler of making the UK the best place to start and scale a business.

For decades the UK has sought, bit by bit, to move the dial in addressing the structural growth capital gap. It is now imperative for us to be bold and make the quantum leap needed to ‘bounce back’ and address - in this new decade - the significant opportunity that innovative scaling businesses represent for the UK and lay to rest the unresolved challenges these companies face when they seek to grow.

The importance of small and medium sized businesses to the health of the UK economy and its citizens’ prosperity is well-known, however SMEs are not homogenous. Within this large grouping of small businesses there exists a rich and diverse collection of fast-growing, productive and innovative enterprises. These scale-up companies have great potential to expand rapidly, to create new products and solutions, to create new jobs, and to improve livelihoods. Across multiple years, they have consistently emphasised the importance of addressing barriers in access to talent, leadership, markets, finance and infrastructure to help them on their journey. Across the first half of 2020 it is notable that the concern about accessing the right finance to fuel their growth has risen sharply in importance, with double the number of scale-ups seeking finance in 2020 compared to 2019.

The ability of the UK to enable businesses to start up and scale - and our scaling companies to scale even further - is being stifled by an ever-widening gap between the capital they need to grow and the capital available to them. Scale-up businesses - those that are growing at greater than 20% in either turnover and/or employment each year - constitute a critical portion of the UK’s SME population. Based upon ONs data 33,860 scale-up SMEs alone represent £1 trillion to the UK economy. This is 50% of all SME turnover. We know these companies are more productive and twice as likely to innovate, and have international businesses than their peers. For the purposes of this report, we have looked at both Scale-up SMEs and in some analysis both scale-ups and those in the broader SME high potential growth population, who have already had an episode of growth and are on the pathway to future scale.

SIZING THE OPPORTUNITY: THE GAP IN GROWTH AND INNOVATION CAPITAL HAS DOUBLED SINCE COVID-19

The Growth Gap is not static but represents a ‘flow’ on an annual basis; unrealised opportunities within one year become unavailable in the next.

The Gap has arisen from long-term, not yet tackled, structural issues. This includes a deficit of institutional patient funds flowing into this market segment, information asymmetries and regional imbalances. It also includes demand-side constraints, limiting the awareness, sophistication and willingness of management to the use of external capital to drive growth. The result is that the UK economy is not benefiting from the dynamic growth that scaling companies can deliver across many sectors and regions. Layered on top of this, we now have the additional cyclical challenge presented by Covid-19, which means we face the risk of significant, long-term impact and going even further backwards in the OECD scaleup rankings.

Based upon contemporary analysis, and wider assessment of historical reports, we estimate the UK long-term Structural gap to be equal £5 billion - £10 billion every year. Whilst not a new problem it is one we have taken a relatively gradual, incremental approach to addressing rather than the definitive bold step it requires. The current crisis has significantly impacted this sub-scale growth ecosystem and has exacerbated the gap which has been effectively doubled by the impact of Covid-19.

The pandemic, combined with the global uncertainty, has created a multiplier effect resulting in a £15bn yearly gap, which needs urgent action to address if we are to achieve our immediate recovery and long-term economic goals. We need to double down across the public and private sector and ‘level up’ across regions, localities and sectors.

Through creating a strong, regional infrastructure that is based on a national framework that is geared towards growth, we believe that we can build back better, with an ecosystem that leverages what works, but draws upon other systems from around the world to provide the best foundation for world beating UK companies. This approach can help to address both the supply-side and demand-side constraints that we identify in this report. Evidence shows the drivers of local growth can be significantly addressed through access to high quality talent, cluster evolution and access to local growth capital: these are key factors to address for sustainable local recovery, exploiting growth opportunities.

The growth gap issue should also not be seen purely through a domestic lens. UK scaleups do not have the benefit of the targeted support that many of the UK’s international peers have developed. Countries surpassing the UK in scaleup growth have a much stronger federated and empowered local governance coupled often with regional development banks and/or sovereign wealth funds with in the US case greater pools of venture debt. In addition they have a more liberal interpretation of the Frascati Manual.

As the UK economy stutters in the wake of Covid-19, this is the moment to address the growth and innovation capital gap with long-term policy solutions that can be practically implemented.
RECOMMENDATIONS

We accept that there is no silver bullet. No single policy or regulatory change that can resolve what was already a complex, long-running issue, now compounded by the extraordinary hit the economy has taken due to Coronavirus.

That is why in this report we make five connected, though distinct recommendations that aim to close the gap for the long-term assessed through a lens of Accelerate, Expand, Align and Create. They are:

1. Create a ‘National Blueprint for Growth’ - that delivers a strategic joined up approach to support and champion more consistent and effective growth across all regions and sectors of the economy.

This should be through a tailored and segmented approach to scaling businesses that addresses the UK’s scaleup systemic issues around talent, markets and infrastructure, with a core long-term growth capital strategy tackling regulatory, legal and structural impediments in the short term. We must also more effectively apply the Frascati Manual as we track our R&D expenditure to ensure we are applying our institutional capabilities effectively.

2. Accelerate the unlocking of Institutional and Corporate Funding - through changes in legislation and organisation that crowds in the existing significant private sector capital that can make inroads into closing the Growth Gap. This should entail developing an aggregator structure with relevant back office analytical and distribution capability. Such a structure could be pursued by transforming British Patient Capital into a joint-venture vehicle with the private sector.

The Government would deploy further seed capital as necessary. Their role in this is to convene and catalyse, with the private sector crowding in around it.

3. Expand the scale and reach of our National Development Banks – Expand and build upon the British Business Bank and continue the developments with Scottish Investment Bank, Development Bank of Wales and Invest NI to develop a network of ‘at scale’ National Development Banks. Further develop, through these entities, empowered regional and devolved hubs with the ability to be agile and deploy funding to sectors and opportunities at speed, through both national and bespoke regionally-designed schemes. Immediately enhance and expand existing schemes, such as the Angel Co-Fund Regional Angel Programme, venture debt and regional funds both to extend runways of existing nascent and developing sectors and opportunities which are yet to emerge. This Fund would be designed to work actively with the overarching growth blueprint set out in Recommendation 1 and the broader enhancements described in wider Recommendations. It could sit as part of a number of existing bodies or be standalone and operate as an entity with the dual role of not only supporting domestic companies but international opportunities similar to a Sovereign Investment Fund.

We believe that the combination of these approaches will finally solve what has been a long-running issue. We have great confidence in entrepreneurial UK Businesses. Their ingenuity, creativity and latent potential for fostering growth and prosperity are considerable. We must give them the tools in the form of growth capital to unlock that potential.

4. Expand the role and scale of Innovate UK – and its direct deployment of innovation & R&D investment capital (via grants and loans) through their Investor Partnership Model, to our most innovative, early stage and scaling businesses.

Expand Innovate UK’s high growth regional relationship management infrastructure and global innovation network, along with the critical partnership opportunities it brings to our scaleups in collaborating with Government, corporates and Universities. This should include expansion of the role and use of SBRI, including its ability to drive procurement with scaling firms and Government as an anchor ‘first’ client, strengthening the Catapult Centres to support regional clusters and further drive forward R&D investment via test beds and technology focused competitions.

5. Create a Future Opportunity Fund - A dedicated Future Opportunity Fund should be developed to allow the UK to effectively engage with emerging sectors and industries such as the carbon net-zero challenge as well as drive forward on wider sustainable goals. This would be ‘purpose driven’ and have the right risk appetite to seed and catalyse long term UK economic growth from nascent and developing sectors and opportunities which are yet to emerge. This Fund would be designed to work actively with the overarching growth blueprint set out in Recommendation 1 and the broader enhancements described in wider Recommendations. It could sit as part of a number of existing bodies or be standalone and operate as an entity with the dual role of not only supporting domestic companies but international opportunities similar to a Sovereign Investment Fund.

This document provides a current assessment of the investor business landscape (section 1). We then provide an assessment of the market failures (section 2), both caused by the current Covid-19 crisis, as well as looking at the structural failures that have become more pronounced because of the current crisis we face. This paper covers in some detail the growth funding gap (section 3), which cut across structural, regulatory and policy barriers, regions, asset class constraints and market dislocation and asymmetries. In the next section (section 4) we share some comparative case studies of the types of instruments that could also be implemented here in the UK. This is then followed by a set of recommendations (section 5).

"The UK has a broad universe of high-growth, scaling businesses and a diverse funding environment. However, COVID-19 has highlighted the need for many of these businesses to have better access to a broader source of funding options and, in particular, equity finance. We welcome the recommendations set out in this report and look forward to working with the ScaleUp Institute, Government and stakeholders across the finance community to develop further solutions to ensure the UK recovers from the pandemic and builds on the underlying strengths of the UK economy." - Marcus Stuttard, Head of UK Primary Markets & AIM at the London Stock Exchange Group

"The 115bn growth capital gap is powerfully revealed in this report. It highlights the inadequacy of UK growth capital flows compared to other countries and the rapid deterioration of a long-standing-market failure – one that is on course to have a devastating impact on future growth, innovation and job creation.

The 40 percent retraction in equity investment at the same time as a 43 percent increase in demand puts in plain sight a deeply concerning trend. Urgent, practical action is needed. Key to unlocking this, as the report asserts, is to create confidence for the long term by scaling up the investment vehicles that already exist. There is a significant opportunity for collective growth if this widening gap is fixed, but only if action is taken once and for all by major investors.

Stephen Welton, Executive Chairman of BGF"
1. INVESTOR AND GROWTH FINANCE LANDSCAPE

The Covid-19 pandemic has placed severe pressure upon existing fault lines in the UK investor ecosystem. As liquidity and wealth capacity tightens in line with global market impacts, this is causing an acute gap of investor engagement in innovating pre-revenue and R&D intensive firms here in the UK.

The nature of the current uncertainty that we face, and the disruption it continues to cause to both consumer demand and behaviour, is disrupting capital flows across all asset classes. Stock market volatility – which is also impacting valuations – is impacting upon liquidity and risk appetite.

Whilst there is some evidence of ongoing international investment activity to UK companies, this international investment has primarily flowed towards specific sectors and more established companies. Wider instability may also alter this picture further across Q3 and Q4 of 2020. The importance of the international picture is illustrated well in analysis by the British Business Bank which notes that UK companies seeking larger rounds of equity finance tend to be backed by overseas investors to provide this capital, which could be a result of UK VC fund size lagging behind US VC funds.

Further, the global nature of the market volatility means that impacts and constraints are being felt by high net worth (HNW) individuals and larger investors alike. With exits dampened in the current climate, VC capacity is also challenged as is the capacity of existing Angel networks.

As we emphasise in more detail in Section 3 of this report, the Angel community has already estimated a gap of £200 million in VC fund size lags. The impact investing landscape is currently estimated to be worth £7 billion in total investment, which will fuel continued growth. However, seed and early-stage venture capital investment has been hit hard, with data published by the Bio Industry Association (BIA) showing seed funding dropped from £11m in Q1 to £2m in Q2, and series A investment was down from £49m to £9m. Compared to the same period last year, seed funding dropped from £11m in Q2 2019 to £2m in Q2 2020, and series A investments were down from £79m to £9m.

The social business sector represents an increasingly important sector of the UK economy and it is one of the fastest growing investment opportunities. However it is also a sector in which access to finance was already seen as a greater challenge before the Covid-19 crisis. The social impact investment market is currently estimated to be worth approximately £3.5 billion and has been growing at around 17% per annum. The effects of Covid and the UK’s exit from the EU are yet to be seen however, in order for this market to reach its full potential all members of the investment community, including the traditional players, must think about how to reach out more effectively to social scaleups and to enable greater levels of investment. The impact investing landscape is further discussed in an insight on page 17.

SECTOR INVESTMENT PERSPECTIVE

Whilst the majority of sectors are in obtaining investment in the first half of 2020, across the board it is lower than in 2019 and acute in certain growth industries such as the creative sector. However, even in those sectors that have been very relevant to the Covid-19 response investment has been mixed. For example, in life sciences, the counter-cyclical nature of the sector and biomedical interest of the pandemic has attracted some of the capital that has been pulled from other sectors such as leisure and retail, which have been more impacted by the shorter-term disruption. More established life science companies, especially those with a Covid-19 products in development, have attracted record sums of public and private capital, which will fuel continued growth.

In contrast, seed and early-stage venture capital investment has been hit hard, with data published by the Bio Industry Association (BIA) showing seed funding dropped from £11m in Q1 to £2m in Q2, and series A investment was down from £49m to £9m. Compared to the same period last year, seed funding dropped from £11m in Q2 2019 to £2m in Q2 2020, and series A investments were down from £79m to £9m.

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REGIONAL DISPARITY

Regional disparities across the UK persist and London continues to be the focal point for equity finance in the UK – the B&B’s Small Business Equity Tracker 2020 shows that London accounted for two thirds of scaling investment deals in the UK in 2019. This represents an increase since 2018 of 37% (£1.5bn) in London, while the rest of the UK only increased by 6% (£160m). London also received £51.5m of investment per 10,000 SMEs and £231m per 100 High Growth Business in comparison with £61m and £284m in the rest of the UK. As our analysis on business demand and in chapter 2 shows this regional gap is only set to widen.

INVESTMENT INSTRUMENTS

The importance of the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) is consistently noted by many scaleups as a cornerstone of early stage growth capital in obtaining funding. As seen in the ScaleUp Institute 2019 Annual Business Survey, for those using equity we see that is from angel and VC investors. Notably, approximately 80% of total investment in angels’ investment portfolios were made through these schemes in 2017 and the British Business Bank’s Angel Market research report of 2018 revealed that 86% of total investment in angel’ investment portfolios were made through these schemes in 2017 and the most recent Angel Market research report of 2019 reveals that 87% of angel investors seek to use the tax reliefs not for tax advantage planning, but to mitigate their risks when investing in small early stage businesses and enabling them to invest more of their income on early stage innovators. Continuous changes to EIS, the Seed Enterprise Investment Scheme (SEIS) and VCTs due to the constraints imposed by State Aid rules creates confusion and can increase the cost
It is often assumed that innovation and growth comes only from young companies. However, the 2019 ScaleUp Index shows that many high-growth and innovative firms are much older than the seven year horizon currently applied. Family firms or other firms where a change in management has occurred, and may spur growth, lose out under current rules.

Younger firms that may have the opportunity to make an acquisition of an older firm may also be deterred from doing so as they will lose tax benefits, causing them to delay or avoid growth. Artificial time limits also create a risk that businesses that reach scale are sold prematurely at exactly the point that they are making the greatest contribution to employment and GDP. Addressing this gap in UK based long-term patient capital that can ‘follow on’ is therefore also an imperative to maintaining UK Intellectual Property.

For instance:
- It is often assumed that innovation and growth comes only from young companies. However, the 2019 ScaleUp Index shows that many high-growth and innovative firms are much older than the seven year horizon currently applied. Family firms or other firms where a change in management has occurred, and may spur growth, lose out under current rules.
- Younger firms that may have the opportunity to make an acquisition of an older firm may also be deterred from doing so as they will lose tax benefits, causing them to delay or avoid growth. Artificial time limits also create a risk that businesses that reach scale are sold prematurely at exactly the point that they are making the greatest contribution to employment and GDP. Addressing this gap in UK based long-term patient capital that can ‘follow on’ is therefore also an imperative to maintaining UK Intellectual Property.

More broadly, the ScaleUp Index 2019 shows that equity investment going into a company is more likely to facilitate continued scale up growth, and recent research has shown equity to be a significant driver of growth at a local level, whereas access to debt does not have this same effect. Expanding the diversity of UK growth funding options is important. Whilst traditional debt does not have a clear correlation with high levels of growth, the success of the Future Fund shows the importance of more flexible debt options such as Venture Debt. As an asset class this can bridge demand side challenges associated with equity, but provide a more manageable growth option for a business than traditional debt. However, this is currently an under-utilised asset class with less Venture Debt offerings in the UK compared to the US, indicating scope for increased additional opportunities in the UK market particularly for fast growing, pre-profit and/or pre-revenue firms scaling at the 5 to 10 percent per year rate. There is appetite for this funding from business, as seen with Barclays Venture debt, backed by EU monies, and Silicon Valley Bank who recognise this gap. However, there are few players currently providing such funding and awareness remains low. In addition EU funding that supported by some of these players is now stilled and needs replenishment through alternative UK sources. Consideration should be given to using the Future Fund as a basis for greater expansion of UK Venture Debt options that can operate at scale, with greater founder and co-investor reach.

More broadly, greater transparency and alignment of potential returns available from investing in UK VC could help unlock more institutional investment in the asset class, which could allow UK VC funds to scale in scale and better meet the funding needs of UK high-growth companies as they scale up.

Figure 1: Factors and their role in scaleup density growth 2013-2018

<table>
<thead>
<tr>
<th>FACTOR</th>
<th>DESCRIPTION</th>
<th>RELATIONSHIP WITH SCALEUP DENSITY GROWTH 2013-2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>SKILLS</td>
<td>Proportion of firms with Level 4+ qualifications. This comes from the most recent Census data (2010) and provides an appropriate lag between the time that young people acquire skills and when they enter the workforce.</td>
<td>Positive up to saturation level</td>
</tr>
<tr>
<td>SECTORAL CLUSTERING</td>
<td>Proportion of companies from the most concentrated sector in a given LAD, obtained using ONS IDBR data.</td>
<td>Positive</td>
</tr>
<tr>
<td>EQUITY</td>
<td>Visible SME equity funding per 100k population in 2013-2014, providing an appropriate period of time for funded SMEs to become scaleups. This data was obtained from Beauhurst's high growth company database.</td>
<td>Positive</td>
</tr>
<tr>
<td>LENDING</td>
<td>SME lending per 100k population in 2013-2014, providing an appropriate period of time for funded SMEs to become scaleups. This was obtained using UK Finance data.</td>
<td>No clear relationship</td>
</tr>
<tr>
<td>LARGE FIRMS</td>
<td>Proportion of firms with 250+ employees in a given LAD. This was obtained using ONS IDBR data.</td>
<td>No clear relationship</td>
</tr>
<tr>
<td>START-UP DENSITY</td>
<td>Start-ups per 100k population in 2012. This data is a necessary to give start-ups a suitable amount of time to become scaleups. This was obtained using ONS IDBR data.</td>
<td>No clear relationship</td>
</tr>
<tr>
<td>START-UP SURVIVAL RATE</td>
<td>Proportion of start-ups from 2012 surviving after 5 years. This was obtained using ONS IDBR data.</td>
<td>No clear relationship</td>
</tr>
<tr>
<td>PUBLIC TRANSPORT</td>
<td>Time to get key services using public transport (England only data), obtained using Goveuk data.</td>
<td>No clear relationship</td>
</tr>
</tbody>
</table>

Source: ONS IDBR 2010-2018, Beauhurst high growth company database.

GROWTH BLUEPRINT

This all points to the importance of addressing the UK’s long standing patient capital gap as part of a comprehensive Growth Policy blueprint to prevent economic scarring from Covid-19. Whilst there are clear investment challenges exacerbated by the crisis, solving long standing structural issues will unlock previously untapped routes to growth.

If we are to make significant and meaningful progress, renewed efforts by government and regulators to tackle the area of regulation identified by the Patient Capital Review’s Pensions Taskforce must be made a priority. By 2025, defined contribution pension schemes will have become one of Britain’s largest reserves – with close to £1trn in capital. If invested into UK enterprises and scaling businesses, the effect could be enormous.

Bold action to ensure that the investors are enabled through regulation and appropriate institutional structures, will help to crowd in private sector money, providing appropriate growth capital to innovative companies, as well as establishing a well curated, regionally responsive ecosystem that can provide direct economic dividends over the longer term.

To address these ongoing investor constraints, for speed and efficiency of execution, taking the ingredients we have today in our financial infrastructures across the public and private sector and, in partnership, dialling up their scale and reach, at a level that will maintain the fastest and most impactful results. This approach also has the advantage of building the one entities that investors and businesses are familiar with, including leveraging existing resource pools. The importance of optimising the scale of current proven providers cannot be underestimated. International learnings show that it is the long-term arm’s length nature of public entities such as KfW and SBA that has driven consistent and sustainable impact as well as scaled interventions. Giving UK institutions sufficient runway and arm’s length empowerment with permanency and flexibility at a regional level under clear national frameworks will generate enhanced results and put us on a footing to our international competitors.

In the last decade we have developed a good basis upon which to build and we now need to accelerate their execution capacity at pace both in reach, and scale for the long-term.

- The British Business Bank and Innovate UK have leveraged the multiplier effects. For example, in the last year, Innovate UK’s grant schemes enabled 642 scaling companies to realise their growth trajectory, unlocking an

EXPLORATION OF GROWTH CAPITAL REPORT

1. 3 British Business Bank Analysis of VC Returns, October 2019
additional £3bn in private capital on top of the £205m of grants provided. Whilst BBB in 2018/19 generated a 3.6 per cent adjusted return on capital employed to Government in its investments, scaling up these infrastructures and their work with the private sector is more efficient than standing up new entities that would drain time, resource and prove an unnecessary distraction in such a critical period.

- 2020 data already reflects some of the key players continuing to make scaleup investments (see Investor landscape) and they offer a starting point for those that can be a foundation to enhanced public/private sector partnerships in co-investment and potential joint venture vehicles that can be further leveraged/co-invested through to operate at greater national and regional scale.

The Government role in this should be to catalyse, convene, set the strategic blueprint and inject a modicum of capital to crowd in the private sector who are ready to step up in addressing these long-term challenges.

**BUSINESS LANDSCAPE AND DEMAND DYNAMICS**

Having the right access to growth capital is a key pillar to scaling up a business. However, UK scaleups have consistently pointed to the problems of finding the right growth finance for their needs.

Data from the SUI Annual ScaleUp Business Survey has shown access to growth capital, across successive years, to be one of the top five challenges for scaling businesses, who particularly wish to see easier access to locally rooted, patient funding.

This is further corroborated in data from scaling businesses responding to the SME Finance Monitor, which has equally reflected that, across multiple years, scaleups perceive that they do not have all of the right finance for their future growth and are uncertain of where to access the right forms of growth capital. Yet we also know from longitudinal data that access to growth capital at a local level is a key driver to demonstrate resilience - and a desire to grow and innovate. In June 2020, the innovation focus of our scaling businesses in their products, services and business models, continued to rise with 62% pivoting and evolving their business models, up from 53% at the beginning of the year.

However, confidence is fragile, and we need to boost their aspirations by laying the right foundations for the recovery by taking bold steps in addressing their financing needs when demand has risen across sectors and regions.

The June 2020 SUI SME ScaleUp Finance Monitor, based on over 900 interviews with scaleup businesses, clearly highlights the ongoing regional and sector demand needs and from our analysis of Beauhurst data, the widening regional and sector gaps in supply.

In all sectors demand is high and investment down but as detailed later in the report particularly acute in certain areas such as creative, retail, and leisure.

**EXPORT AND SUPPLY CHAIN DEMANDS**

Scaling businesses are strong exporters with aspirations to do more. As Covid-19 has hit these ambitions remain, but confidence has been dampened due to concerns about supply chains and prompt payment, reflecting the uncertainty of buyers behaviours.

**INFORMATION ASYMMETRY - KNOWLEDGE AND DEMAND**

Whilst scaling businesses are much higher users of equity and finance than their SME counterparts, reservations about the use of equity finance do persist. There remains perceptions of complexity and/or unsuitability and fears of having to ’give up control’ - all are still cited as reasons for not progressing such a finance option.

Increasing the provision of education about growth capital and myth-busting common misconceptions is vital in order to ensure that scaleup leaders are fully aware of all the available finance options as they make choices about their growth. Financial providers working more closely with local communities are necessary in order to provide tailored solutions for scaleups where they are based.

In recent work that the ScaleUp Institute has conducted with UKBA and the British Business Bank network teams in regional roundtables, the following information asymmetry themes have consistently been raised as needing resolution.

These issues and opportunities, highlighted below, can be addressed as part of a National Blueprint for Growth.

Mark Brownridge, Director General, EISA

The Growth Capital report gets to the very heart of the problem facing early stage and scaleup businesses in the UK in the face of the coronavirus pandemic, namely the chronic lack of equity funding available to such businesses across all of the UK, but particularly in the region. The report zeroes in on why equity funding is so important and sets out a coherent plan for expanding existing schemes alongside new, innovative funding ideas to help UK scaleups realise their ambitions and deliver desperately needed growth to the UK economy.
Better use of Data

Data remains fundamental to ensure investors and ecosystems at a national and regional level can engage on a timely basis with companies that have the potential to scale and make sure that our scaling businesses get the right support at the right time to foster their continued growth. There is a need for the public and private sector to better harness data to ensure better targeted activities and interventions. Open Banking can help in this regard as well as continuing work in Government to harness HMRC data, to identify and proactively engage with scaling businesses, to fast track them to relevant solutions. As part of a Growth blueprint and renewed Data strategy the work the Government has underway in the DECA project should continue and Government should continue to assess future the ability to further open up data channels via APIs to better link businesses to effective growth capital solutions.

Building awareness across the Advisory and Business community

Creating better understanding among the local business population and providing the right services at the right time is vital to ensure that growth can be encouraged. Physical Hubs with structured briefings and Investor Enablers such as those in Bristol and in some LEPs/Growth Hubs, as well as online resources can play a greater role. The British Business Bank’s Finance Hub and Regional Network is increasingly being recognised as an important source of impartial guidance, playing an important role in breaking down knowledge barriers amongst businesses and the wider ecosystem. These services should continue to be expanded upon as well as those of InnovateUK’s Enterprise Network and Investor Partnership.

Connectivity and referral systems need development - ‘Coventry is not Birmingham… Oxford is not Oxfordshire’

Referrals for businesses seeking growth capital - including follow on funding - is currently very fragmented and often based upon informal networks. The referral mechanism under the auspices of the Small Business Act is appropriate for debt. The finance sector in local areas should consider what can be further achieved for referrals between growth capital funders that is more systemised. Developing a more streamlined approach in local areas would help to save companies time and effort and underpin wider work to improve ecosystem connectivity. Effort needs to be made in ensuring finance networks; workshops; investment reaches all areas of a community and locality - city connectivity does not mean regional connectivity.

The British Business Bank’s Finance Hub can play an important role here as can learnings from the Future Fund which has had much better reach into diverse geographies and founders than other financial providers. Learnings should also be drawn from the Basket Bond launched by ELITE (part of LSEG/Borsa Italiana) in Italy.

Effective advice needs tailoring, segmenting and relationship focus

Scaleups appreciate a relationship approach to finance and often a neutral environment where they can go for initial conversations about available funds. Upskilling local ecosystems, players is core to ensuring that the best information is available, particularly in relation to growth capital. More effort is needed to segment businesses according to their growth life cycle and stage in the scaling journey. Government should be adopting a segmented and relationship driven approach across all local and national services. This will help address demand barriers and information asymmetries stated above, and has the potential to make significant inroads in enabling businesses to navigate interventions and access the right service at the right time: simplifying the process, reducing friction and accelerating opportunities. Such an approach has had proven results in Scotland, Denmark, Innovate UK’s EEN, and the ScaleUp Directors programme, which should continue to be built upon, including the evolving relationship management approach in LEPs and Growth Hubs. This relationship management structure should be underpinned by strong CRM systems to enable better connectivity and customer cross referral.

Networks need extending and coordinating

Scaleup leaders acknowledge that advisers are generally well networked but not necessarily aware of all initiatives. Currently many business connections are informal and fragmented; business support providers need to identify these informal networks to make sure they have the right information on the finance available to scaleups. Professional service providers, such as legal and accountancy practices, and frontline staff in high street banks have a key role to play and need to also be up to date and connected to the wider finance options available to be able to share information with their clients. There is also the opportunity to expand the role of peer to peer networks in tandem with the private sector and the Government’s recent announcements in this area are welcomed.

Open up connections to non-executive directors

In many areas of the country scaleups are constrained by access to talent with the right skills to help them grow. NEDs and mentors can help to provide expertise and guidance, as can temporary Finance Directors in place for a particular period of time with a business. Better visibility of what who and are available and a trusted source of information on quality is needed to unlock these resources for a greater number of businesses. Business Schools can also play an important role and provide resources to link scaleup leaders with sources of expertise and should consider evolution of alumni Angel networks such as in Henley and Aston.

The social business sector is still developing but it represents an increasingly important sector of the UK, and it is one of the fastest growing investment opportunities. As the number of social businesses increases, so will the number of social scaleups. Approximately 22% of all SMEs are socially oriented which places the number of social scaleups in the region of 8,000 businesses. Several factors have contributed to the growth of the social business sector including the Social Value Act, which has added social impact considerations to public sector procurement procedures, and the establishment of new entities like Big Society Capital and the Inclusive Economy Unit within DCMS.

Given the impact of social businesses, it is vital that we understand the needs of social scaleups to support them to flourish and achieve the greatest possible impact especially in the context of recovery from social, economic and health crises, such as Covid-19. Social scaleups cite talent and skills alongside access to markets as their principal issues. This is consistent with the views of the wider scaleup community. They also highly value access to peer networks, local solutions and mentoring.

Notably, however, access to finance is seen to be a greater challenge to social scaleups than for their fast growing peers in other sectors of the economy. While there has been growth in the scale and visibility of the UK’s impact investing sector (see the Spectrum of Capital below), there is a clear need to ensure that the leaders of social scaleups can access finance and understand the available options. A majority of social scaleup businesses (62%) say they do not have the right amount of finance in place. In addition, significantly, social businesses are more likely to cite access to bank finance and equity finance as vital/very important barriers to growth (57% of social businesses, versus 43% across all survey respondents, and 38% versus 24% respectively).

Given that only 26% of social businesses use equity finance currently, there is an opportunity to better serve businesses that plan to use it in the near future (51%), don’t know where to start in the process (9%) or don’t know enough about this type of finance (20%).

The Spectrum of Capital6

Source: Bridges Fund Management and The Impact Management Project 2017

6 https://www.bvca.co.uk/Our-Industry/Impact-Investment/What-is-Impact-Investment
Analysis of the impact investment market conducted by the ScaleUp Institute and Barclays in 2019 identified that at least £446m of equity investment has gone into 226 distinct UK social businesses since 2015, with average deal size doubling from £0.81m (2015) to £1.58m (2018).

The UK is rightly seen as pioneer in this sector, the social investment market is estimated to be worth approximately £3.5 billion\(^7\) and has seen an annual growth rate of 17 per cent, however some forecasts have suggested that social investment could grow at 38 per cent a year. The BVCA has identified a range of factors behind this rapid growth in the sector:\(^8\)

- The growing awareness that responsible business behaviour and strong Environmental, Social and Governance (ESG) practices can not only reduce harm to people and the planet but also create value and actively contribute to solutions to societal challenges.
- The emergence of the United Nations Sustainable Development Goals (UN SDGs) as a framework to raise awareness of and address these societal challenges.
- The rise of a new generation of entrepreneurs, many of them based in the UK, who believe commercial business can play a part in helping to solve these challenges at scale – increasing the availability of investable opportunities.
- The emergence of a new wave of customers (particularly among the millennial generation) who believe their buying choices should align with their personal values, and as such are keen to support 'profit with purpose' businesses – creating a sizeable market opportunity.
- The growing body of evidence that by tapping into this market opportunity, impact investment can achieve returns in line with (and sometimes in excess of) traditional investment.

However, challenges remain including: data issues which limit our ability to identify scaleup social businesses and to understand the full breadth of the impact investment market; concerns from traditional investors around return profiles; and, a lack of infrastructure which supports collaboration between the range of investors and intermediaries involved – evidence shows the variety of different types of investors engaged with social businesses, some with an impact focus and some with a more general focus (including bodies such as Innovate UK and Funding London). The withdrawal of EIS funding from the UK will also present challenges for impact funds, with indicative research in the sector shared with the authors of this report suggesting that fundraising has already been affected.

It is both a challenge and an opportunity for the financial community, including the traditional players, to think harder about how to reach out more effectively to scaleups and to enable greater levels of investment. It is why as part of our recommendations we highlight the creation of a Future Opportunity Fund to set aside funding for businesses rapidly growing across the 5% to 20% spectrum serving new and emerging sectors. This Fund would also have a remit to foster strategic Green Economy 'carbon net zero' and sustainable development goals and be capable of execution through co-investment and guarantee models. The Government could ringfence goals and be capable of execution through co-investment and guarantee models. The Government could ringfence such a Fund within existing infrastructures, such as Big Society Capital, British Business Bank, Innovate UK, or as a standalone investment vehicle, as was previously in place with the Green Investment Bank.

It has never been more important to support the early stage, scale-up and high growth segments of the UK economy. The Growth Capital Report highlights the structural opportunities for strategic longer-term capital to support these ecosystems, as well as drive key aspects of the diversity and leveling-up agenda.

Ben Davey, CEO, Barclays Ventures

### 2. THE MARKET FAILURES

The evidence described above on the latest investor and growth finance landscape points to both longstanding (structural) and crisis-related (cyclical) challenges in delivering growth capital to scaleups. High growth firms face accumulated pressures from the Covid-19 crisis against a backdrop of substantial institutional change as we exit the EU. But there is also reason for optimism. The evolution of public infrastructure to support the flow of growth capital can be linked to recent improvements, in particular during 2019.

In this context, it is vital to be clear on the potential causes of the gap in growth funding, and in particular, why available capital is not reaching scaleup firms even though those investments offer potentially higher risk-adjusted returns to investors. These potential causes therefore represent market failures, stopping the market from delivering funding to economic opportunities. We consider these market failures below, distinguishing between the structural issues that existed pre-Covid-19 and have been further exacerbated by the crisis, and the cyclical issues that arose due to the Covid-19 crisis. These market failures then provide the basis for estimating the size of the gap (in Section 3) and identifying the strategic solutions that are required to address them (in Section 4).

It has been a privilege to contribute to this report. We need a step change in the flow of growth capital into UK businesses. To the well-known growth capital funding gap that has been around for as long as I can remember since working at ICFC in the 70s and 80s, there has now been added a further similar scale funding gap created by the pandemic and lockdown. Our challenge is to take the right steps immediately to fund businesses and protect jobs but importantly to provide much more capital for investment, otherwise the UK economy will face a growing catastrophe and falter. Besides increasing the quantum of growth capital, there are three other critical factors: speed – we need to act immediately to avoid more business failures and job losses as working capital dries up; relax the rules – for a period, we should relax the rules that stifle rather than encourage investment, for example State Aid; and greater financial support for the regions - building on the existing infrastructure to get funding to where it is needed fast.

I and my colleagues at Foresight look forward to playing our full part in funding the recovery and growth of UK business.

David Hughes, Chief Investment Officer, Foresight Group

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8 https://www.bvca.co.uk/Out-Industry/Impact-Investment
9 Research by Beauhurst shows 29 social impact funds operating in the UK, however at present the scale of these investors is limited to small and earlier stage investments.
**STRUCTURAL MARKET FAILURES**

The pre-Covid-19 gap in growth funding has been driven by longstanding structural market failures, which have been exacerbated by the Covid-19 crisis. From the evidence presented in this report, and our discussions with stakeholders and market participants, four key structural market failures have been identified.

1. **AN UNCOORDINATED APPROACH HAS CREATED REGULATORY AND POLICY BARRIERS WHICH IMPED THE FLOW OF FUNDS**

   The evolution of public infrastructure and various initiatives has done much to support growth capital in recent years, but the patchwork approach has resulted in barriers to the flow of funds from different types of investors, ranging from pension funds, private equity and angel investors. For example, VCTs can only invest in certain companies if they are less than ten years old, and an array of requirements for pension funds limit their interest in growth capital investments. Such regulatory barriers to the flow funds represent a limitation on the effectiveness of the market to deliver growth capital, particularly in the context of the current crisis where the availability of funds is restricted in general.

2. **LACK OF CAPACITY AND DEPTH IN THE REGIONS BEYOND LONDON AND THE SOUTH EAST TO DELIVER GROWTH FUNDING**

   The capacity of existing infrastructure to deliver funding to scaling high-growth firms is often limited in terms of scale and scope. This is driven by insufficient density of opportunities and funding pools, resulting in inefficiencies and ultimately a high cost overhead vs cost of capital. There are some success stories, such as with the Development Bank of Wales (Appendix B) and Northern Powerhouse, but much remains to be done. With the importance of the levelling up agenda, ensuring inclusive sustainable growth across the whole of the UK will be vital. Forward-looking schemes must address diversity and regional disparities.

3. **LACK OF SCALE AND DEPTH IN FOLLOW-ON FUNDING DUE TO LIMITATIONS IN CURRENT RANGE OF FUNDING MECHANISMS**

   The UK has faced a longstanding challenge in delivering the capital required by scaleup companies, in terms of cost of deployment, reach and perceived return. Success in funding start-ups has not translated into similar success in providing the larger amounts of funding required at later stages of growth, resulting in limited access to capital, or the cost of capital being too high, deterring management and owners from using external capital sources. There exist considerable potential sources of finance, from pension funds and corporate players, but successfully channelling those funds to fast-growing businesses can face many hurdles. Large institutional investors are not equipped with the resources required to invest in small businesses, so effective infrastructure (e.g., introduction of aggregators) is required to support the channelling of funds.

4. **INFORMATION, COLLABORATION AND CONNECTIVITY ASYMMETRIES LIMITING THE USE OF EXTERNAL CAPITAL TO REALISE FULL GROWTH POTENTIAL**

   Another longstanding challenge, explored in detail in previous studies, arises from the awareness, sophistication and willingness of management to the use of external capital to drive growth. Studies identify challenges for SMEs, including a lack of resources and managerial systems, the centrality of founders with a focus more on the customer and product than financing opportunities, and a simple lack of experience of owners and managers in the use of external capital. External capital is expensive, but a necessity for achieving scale. Addressing attitudes and information asymmetries is challenging, and a key challenge for the various agencies that exist to foster growth capital, including the BBB, IUK and BSC.

**CYCLICAL MARKET FAILURES**

Past crises, such as the global financial crisis, have negatively impacted on the flow of growth capital for a number of years beyond the economic recovery beginning, and again in this crisis we observe a number of potential new cyclical challenges arising. Four cyclical market failures are set out below:

5. **GROWTH CAPITAL FLOWS ARE NOT SUFICIENTLY RESILIENT AND FLEXIBLE THROUGH THIS CRISIS**

   Over the past ten years we have seen SME growth investment held back by the long-running impact of the Global Financial Crisis (GFC), then after a short period of recovery 2014-16 impacted by the Brexit decision, and now, again after a short recovery, impacted by Covid-19. This has resulted in a volatile and uncertain environment, contributing significantly to the growth capital gap. The GFC saw a negative impact on the banking sector (not as apparent in this crisis), but the Covid-19 crisis presents new challenges, for example, due to the restrictions on social interactions and travel, which can create practical difficulties in dealing with investment needs. More specifically, the UK does not have deep pools of angel, VC or Venture Debt funds, or ‘follow on funds’, which means these challenges threaten the resilience and flexibility of capital flows that is required. Specific measures aimed at addressing these impacts on the resilience and flexibility of funding mechanisms are therefore required.

6. **INCREASED UNCERTAINTY AND REDUCED RISK TOLERANCE OF INVESTORS LIMITS INTEREST IN NEW OPPORTUNITIES**

   The provision of long-term certainty to institutions, individuals and companies that are looking to invest is key. One thing that the Covid-19 crisis has in common with past crises is the negative impact on risk tolerance and longer-term certainty. We have seen investors channel funds to help support existing businesses rather than take on new opportunities, which reflects this dynamic. It is a natural outcome of the market that an increase in the rate of return required by investors, and a reduction in the expected future returns of businesses, results in a reduction in the amount of investment. However, in an environment of reduced risk tolerance, the impact of rigidities in market mechanisms are heightened and the need for flexibility and resilience increased.

7. **GOVERNMENT SUPPORTED CRISIS LIQUIDITY SUPPORT (INADVERTENTLY) CROWDS OUT GROWTH FUNDING**

   The response of governments and central banks across Europe and elsewhere has been striking, immediately delivering a huge wave of support measures that have provided businesses with the liquidity that many require to survive. There can be little doubt that this has been vital for protecting the economy from the immediate negative impacts of the crisis. It has resulted in considerable liquidity available to businesses, primarily through various government supported lending schemes and grants. It is however also vital that this liquidity does not inadvertently crowd out investment to fast-growing smaller companies. The rules around government support can penalise growth companies, for example, limiting support to loss-making businesses, which may simply be a reflection of a business being in a rapid growth phase. Government support may also tend to flow to existing businesses, which may prop up uneconomic incumbents to the expense of new businesses with better opportunities. It is therefore vital that the needs of growth capital are carefully considered as part of the government response to the recovery.

8. **OVERSEAS INVESTMENT IS FRAGILE AND HIGHLY SPECIFIC, SO MUST BE ADDRESSED ACCORDINGLY ACROSS THE UK GROWTH LANDSCAPE**

   While the UK has made significant improvements in the flow of overseas investment before the crisis, this success has been put at threat by the Covid-19 crisis, bringing international travel largely to a halt and has largely depressed global trade and business interactions and enhanced stock market volatility. In such an environment, foreign direct investment will be challenging. Once this crisis is over, these pressures should diminish, although there is a risk that longer-lasting damage may have been caused, that needs to be addressed.

Growing UK businesses don’t lack strategy, ambition or talent, but even before the Covid-19 crisis all too often, they were not getting the finance they need to take their business to the next level. This report is a valuable contribution to the debate about how to address the UK’s growth finance gap. We have an opportunity to make the UK the best place in the world to start and grow a business as we build back better. By leveraging existing networks and frameworks, we can ensure businesses across every region and nation of the UK can access the right funding to supercharge their business and power the recovery.

Rain Newton-Smith, Chief Economist, CBI
3. THE GAP EXPLAINED

A range of pre-existing weaknesses have challenged the UK in its scale and depth of Growth and Innovation Capital. These cut across structural, regulatory and policy barriers, sectors and regions, asset class constraints and market dislocation and asymmetries. The gap in growth and innovation capital, representing missed opportunities, has doubled since Covid-19. The Growth Gap is not static but represents a ‘flow’ on an annual basis with unrealised opportunities within one year becoming unavailable in the next. This kind of structural gap means that the UK economy is not benefiting from the dynamic growth that scaleup companies can deliver across many sectors and areas of the UK economy. With the cyclical challenge presented by Covid-19 layered on top of this we face the risk of significant, long-term impact and going even further backwards in the OECD ranking of countries where a business can scale.

Based upon contemporary analysis, and wider assessment of historical reports, we estimate the UK long-term Structural gap to be equal £5- £10 billion every year. This is not a new problem but it has been effectively doubled by the impact of Covid-19, with a further £7.5 billion created by the current crisis. This pandemic, combined with the global uncertainty, has created a multiplier effect resulting in a £15 billion yearly gap, which needs urgent action to address if we are to achieve our immediate recovery and long-term economic goals.

Our work on identifying the options for addressing this gap - both the structural gap that existed before Covid-19 and the cyclical gap that has arisen due to Covid-19 - begins first with understanding just how large this gap might be. We have done this by drawing on the existing estimates (primarily of the structural gap) and then building on to them the changes in both the supply and demand for capital that we observe in the current crisis. This approach allows us to both assess the quantum and also link it to the potential causes - and hence potential solutions. We have explored a range of different drivers and dimensions of the gap, producing a range of cross-cutting estimates that are summarised in Figure 4, and explored in further detail below.

Our estimates of the pre-existing Growth Capital gap, described in detail below, point to a gap of around £5- £10bn per annum in the post Global Financial Crisis period (2011-19).

This structural growth capital gap has many layers and goes beyond the pre-existing gap that we have observed in recent years. There may be additional demands for funding from future challenges, such as addressing the carbon net zero challenge, or there may be missed opportunities. In 2019 a further lens was brought to bear with the Rose Review, and work by the British Business Bank, for example, showing that all female founder teams get less than 1% of venture capital (VC) funding, and mixed teams getting only 10%. Furthermore, the ongoing exit from the European Union is likely to create additional needs, both due to losses of sources of growth funding (such as from the European Regional Development Fund (ERDF) and European Investment Bank / Fund (EIB / EIF)) as well as new opportunities for funding that may arise.

UKBAA welcomes the Growth Capital Report presenting a five point plan for Funding to catalyse small business growth. These proposals are wide ranging and recognise the importance of addressing the existing regulatory and structural imbalances for access to capital and notably for regional businesses, as well as for women-led businesses and other under represented groups. We are especially pleased that the importance of further boosting Angel investment capacity across the UK and the role of the EIS scheme are identified as a core part of this segmented strategy for funding future business growth.

Jenny Tooth, CEO, UKBAA

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3.1. THE STRUCTURAL GROWTH CAPITAL GAP PRE-COVID-19

Our estimates of the pre-existing Growth Capital gap, described in detail below, point to a gap of around £5-£10bn per annum in the post Global Financial Crisis period (2011-19).

This structural growth capital gap has many layers and goes beyond the pre-existing gap that we have observed in recent years. There may be additional demands for funding from future challenges, such as addressing the carbon net zero challenge, or there may be missed opportunities. In 2019 a further lens was brought to bear with the Rose Review, and work by the British Business Bank, for example, showing that all female founder teams get less than 1% of venture capital (VC) funding, and mixed teams getting only 10%. Furthermore, the ongoing exit from the European Union is likely to create additional needs, both due to losses of sources of growth funding (such as from the European Regional Development Fund (ERDF) and European Investment Bank / Fund (EIB / EIF)) as well as new opportunities for funding that may arise.

We set out selected evidence on the structural gap below. This gap of around £5-£10bn per annum compares to estimated investment by high growth small and medium sized businesses of approximately £60 billion per annum, and suggests that closing the gap could increase their investment by around 12.5-25%. The broad range of these estimates is driven in part by the gap having varied significantly from year-to-year, as both the supply and demand for growth capital evolved over time, including in response to developing events. Below we explore a wide range of approaches for assessing the structural gap, exploring the drivers and dimensions set out in Figure 4 above, including:

- Selected estimates of the pre-Covid-19 gap, developed by researchers in recent years
- The gap based on potential demand for capital, based on Beauhurst analysis developed with the Scaleup Institute
- The gap based on the potential supply of capital, considering what sources may exist to fill the gap
- Macroeconomic indicators of the growth capital gap, looking at SME investment trends
- Regional analysis of the growth capital gap, exploring the segmentation by region
SELECTED ESTIMATES OF THE PRE-COVID-19 GAP

Various reports have provided estimates of the growth capital gap since the Global Financial Crisis. They include estimates both of a ‘stock’ of outstanding opportunities that are not being funded, as well as estimates of a lack of ‘flow’ of growth capital. The two are of course related, and potentially interchangeable given assumptions for the longevity of unfunded opportunities. Selected numbers include:

An earlier estimate of the ‘stock’ from Deloitte, which fed into the evidence behind the creation of the British Business Bank, suggested that the SME funding gap in 2013 was around £10 billion to £11 billion (central estimate), and by 2017 this figure was projected to rise to about £22 billion.

- More recently, the growth capital ‘flow’ gap was assessed by the Industry Panel reporting to the Patent Capital Review in 2017, which estimated the annual UK flow gap as between £3-6bn.
- An estimate of the ‘stock’ prepared by BlackRock for this report suggests that equity funding for scaleups has been around US$40 billion lower than would be expected compared to the US, over a ten year period (which equates to around UK£3-4bn per year).

There is a fair degree of consistency amongst these estimates for a growth capital gap of around £3-6 billion per annum, in terms of a flow. Each estimate is different, and arguably all of them have omissions compared to our somewhat broader concept, but the broad consistency - for a concept that is undoubtedly with a wide degree of uncertainty - is reassuring.

THE GAP BASED ON THE POTENTIAL DEMAND FOR CAPITAL

An alternative perspective of the growth capital gap considers the potential demand for funding from scaling firms - representing scaleups and those growth firms with high potential that have not yet raised funding.

In a recent analysis conducted with the Scaleup Institute, Beauhurst estimated the potential demand for growth capital from all of the fast-growing and potentially fast-growing firms that it has identified to be in the order of £118 billion. This is an estimate of the stock of outstanding capital investment opportunities, which comprised of some £3 billion from ‘seed stage’ firms, £45bn from ‘venture stage’ firms, £45bn from ‘growth stage’ firms and £66bn from ‘established’ firms.

In terms of an equivalent flow estimate, one might expect to ideally meet the demand for capital over a period of time, with the amount of time being shorter for seed stage and longer for established for example. In addition, some of the firms included would perhaps never be ready for investment. If one assumes that the lifespan of opportunities varies from between two years (for seed) to ten years (for established); this would suggest that a flow of around £118bn per annum would be required if all firms sought capital. So even with relatively prudent assumptions on the proportion likely to do so, the estimate of the stock of outstanding opportunities would appear consistent with a somewhat higher estimate of an annual gap (compared to the studies described above), perhaps circa £10bn per annum.

This approach also provides a basis for estimating demand for capital across different stages of development, suggesting that the annual requirement for a total capital level given by the midpoint of our structural gap range (£7.5bn) would be:

- Seed stage: £0.7bn
- Venture stage: £0.7bn
- Growth stage: £3.2bn
- Established: £3.6bn

THE GAP BASED ON THE POTENTIAL SUPPLY OF CAPITAL

Another alternative perspective on the growth capital gap is whether there are clear gaps in the supply of capital that could be addressed, to ensure that the estimates of the gap could feasibly be met without needing to increase the overall volume of savings available - which ultimately constrains the amount of investment.

For the UK economy, one major source of potential funding is from private pensions, including both defined contribution (DC) and defined benefit (DB) occupational schemes, as well as personal pensions. Total pension wealth in the UK was estimated by the ONS to be in excess of £6.6 trillion during the April 2016 to March 2018 period, and is one of the largest components of UK financial wealth. A review of the massive source of wealth indicates that there is easily sufficient scale to meet the estimates of the gap being considered in this report, as we outline here.

Starting with DC pensions, which have significantly lower current assets under management than the more established DB pensions (£3.174 billion, compared to £3.374 billion - neither figure including pensions in payment); there is clear scope for increased investment into scaleups (high growth) firms. As detailed by Oliver Wyman in a report commissioned by the British Business Bank, DC pensions only invest 13% of their assets in alternative asset classes, including VC funds, compared to 24% for DB pensions. This gap is linked to regulatory and commercial factors encouraging high liquidity and low asset management fees, even though high return, illiquid assets would seem quite appropriate for the generally long-term perspective of DC funds. DC pensions have a high level of contributions, of around £60 billion per annum, and if the proportion of this new money flowing in to support scaleup companies was adjusted to close the current funding gap, it would point to an additional flow of around £6 billion per annum.

Add to this further potential flows from [the much larger] DB pension funds and also personal pension funds, it is clear that additional funding of £13.1bn per annum is feasible from UK pension funds alone. This suggests that the scale of the gap being considered here is quite reasonable in terms of what the wider asset management industry could be capable of delivering.

MACROECONOMIC INDICATORS OF THE GROWTH CAPITAL GAP

The challenge in ensuring UK scaleup businesses have access to the funding they require to grow can also be observed in macroeconomic data since the global financial crisis. Official ONS data for the UK shows that after the global financial crisis, business investment by SMEs was suppressed until 2014, long after the partial recovery in investment by larger firms in 2011 - as illustrated in Figure 5 below. The recovery in SME business investment in 2014 - which we expect was driven in a large part by scaleup companies - coincided with the long-awaited recovery of the economy from the long-running recession. This recovery in SME investment was short-lived, however, falling again in 2017 due to the uncertainty created by the Brexit decision. There is some evidence to suggest that business investment in the UK as a % of gross value added that business investment in this community improved again somewhat in 2019, but any such recovery was short-lived due to the impact of Covid-19 from Q1 2020. Throughout the period, investment by SMEs has always been at a much lower level, relative to gross value-added, compared to larger companies.

This persistent weakness of investment by SMEs since the last recession reflects the challenges that the UK has faced. The weakness of the banking sector constrained the availability of lending to scaleups for a long period following the global financial crisis, and then the partial recovery in 2014-16 was knocked back again by events. This points to weaknesses in the infrastructure that is required to ensure a consistent flow of capital to high growth companies. This is not only important for rekindling economic growth following downturns, but also because our scaling businesses are our sources of innovation and technology that will help us address the current and future crises.

It is also possible to estimate the gap based on official statistics for capital investment by businesses (which includes investment in intellectual capital, and thereby includes R&D). While not all growth capital is required to fund capital investment (some might be required for working capital, for example), and not all capital investment is linked to growth (some investment is required simply to maintain the capital stock of the UK), there should be a broad correlation. The analysis below, in Figure 5, suggests that investment by SMEs over the period 2011-2018 was some £13bn per annum lower, on average, than it would have been if the more buoyant investment levels of 2014-16 had been maintained. A higher estimate of £24.3bn per annum would be implied by the rate of investment of larger companies observed in the UK during the full 2018-19 period - which is widely considered to have been a period of weak business investment in the UK.
3.2. THE CYCLICAL GROWTH CAPITAL GAP DUE TO THE COVID-19 CRISIS

We estimate that over the twelve months including Q2 2020 to Q1 2021, the impact of Covid-19 on the availability of growth capital for scaleups is set to be in the order of an additional c.£7.5bn, on top of the pre-existing structural gap of £5-£10bn per annum. This additional cyclical gap therefore represents a doubling of the growth capital gap due to the impact of the Covid-19 crisis, and further underlines the importance of addressing longstanding issues in delivering funding to fast growing businesses. Our estimate is based on an assessment of the impact of the crisis on both the supply of, and demand for, growth capital - as summarised below. This comprises of the following elements:

- The impact of the Covid-19 crisis on the supply of growth capital, including:
  - The impact of operating losses (or, in some cases, gains) on the resources of the business and its owners to fund growth
  - The offsetting impact of government-supported lending and grants
  - The loss of external capital to fund growth, including both equity and debt funding
- The impact of the Covid-19 crisis on the demand for growth capital, including:
  - The loss of growth opportunities due to the crisis; both in the short term (e.g., due to social distancing measures) and in the longer term (e.g., due to changes in behaviour that persist)
  - New opportunities due to the crisis, due to changes in behaviour and economic structures, as well as due to the failure of incumbent business competitors

The elements define the supply of and demand for growth capital, and the difference between them defines the growth capital gap.

IMPACT ON THE SUPPLY OF GROWTH CAPITAL

Regarding the supply of growth capital, the impact of the Covid-19 crisis is gradually becoming clearer in the evolving data available from market participants and official sources. But significant question marks continue to surround how the crisis may impact on markets and the economy going forward.

Analysis conducted with ScaleUp Institute by Beauhurst shows that external equity funding to fast-growing businesses fell by approximately 40% in Q2 2020 compared to Q2 2019. The impact is potentially even more severe in Q3 2020 as Q2 will have benefitted to some extent by deals already put in place, and also flattened by additional equity funding provided to existing businesses to support recapitalisation, rather than growth. We expect reduced equity funding throughout 2020, suggesting an overall drop of 40%, or £6 billion, is not unreasonable to assume².

We believe the impact is primarily on growing businesses that have not yet reached sufficient scale to use public equity markets, although there is still some evidence that the availability of growth capital from the AIM market has fallen significantly. Looking at AIM data, we see that there was a significant amount of equity funding in Q2 2020, primarily aimed at recapitalising existing businesses. Compared to Q2 2020, the amount of equity capital raised where there was some indication that the purpose was for growth or acquisitions fell by around 45%, however, between Q1 and Q2. A fall in 45% in growth capital funding is broadly consistent with the Beauhurst findings for a wider universe of businesses.

In addition, market participants indicate that the availability of lending products suitable for high growth businesses has been curtailed, in part due to the flood of state-backed plain vanilla lending during the crisis. This reduction in ‘venture debt’ inevitably adds to the loss of funding.

Angel investors have also seen a reduction in available supply of funding. The UK Business Angels Association (UKBAA) surveyed their members in April 2020 and estimated that there is a current unmet demand for growth capital of £200 million. On average, the surveyed angel investors had seen a 45% reduction in funding, similar to the estimates above for wider equity sources².²

We also estimate a c.£300 million impact on venture capital, although this is quite uncertain at this time, and based on a patchwork of different estimates.

Overall, an assumption of a reduction in the supply of external growth capital of around £5-10 billion would seem relatively prudent for the next twelve months. Given that crises have tended to negatively impact on the supply of finance to SMEs for longer than expected in the past, this deficit could persist for quite some time. In addition, it is likely that high growth businesses have seen a loss of own resources for funding investment that has not been fully compensated by state-backed grants and lending.

This would therefore suggest that the additional impact of the Covid-19 crisis on the growth capital gap is at midpoint of the £5-£10 billion per annum range - which is £7.5 billion per annum.

² Beauhurst estimate that the total amount of equity funding to fast growing businesses was £5.6bn in 2019. 40% of this figure is £6bn.
IMPART ON THE DEMAND FOR GROWTH CAPITAL

Economic downturns inevitably result, at least in the short run, in some loss of opportunities, which in turn results in some loss of demand from high growth firms for growth capital. But downturns also create new opportunities, both due to the loss of incumbent businesses (creating opportunities for new entrants) and due to structural change in the economy, which typically results from recessions. In the case of the current crisis, the potential for very significant structural change is particularly pronounced, due to the severe impacts on behaviour, which will likely persist for some time.

So the impact of Covid-19 on high growth firms, and hence the growth capital that they seek, will inevitably be a mix of lost and new opportunities, and the overall balance of impacts could be in either direction. This comes on top of the capital that many of them are also seeking to cover the direct negative impact of the Covid-19 crisis - which we refer to as recapitalisation.

It is perhaps too early to tell how much structural change there might be, and how the balance of opportunities will evolve. However, early indicators suggest that considerable demand for growth capital remains. The ScaleUp Institute has estimated that demand for finance from scaling businesses has increased significantly, with 43% of scaleups seeking capital for growth purposes in the three months to May 2020, compared to 27% before the crisis. This is almost double the number of scaleups looking for finance seen in recent years and coincides with such businesses also having heightened concern over the challenge to access suitable patient funds.

Cash runway is also a concern in some of our most innovative firms. A recent survey of FinTech companies by Innovate Finance show that nearly 70% of smaller UK FinTech companies have a cash runway of 6 months or less.

In addition, the ScaleUp Institute has also reviewed the announced purpose of funding deals in 2019 and 2020 so far, to shine some light on how demand has shifted due to Covid-19. Of the 389 businesses that have announced what the funding is for in 2020, we can see that the top two reasons for funding is job creation and research, and this has flipped in 2020 with R&D the priority focus. The proportion of funding for ‘working capital’ has increased significantly in 2020 as well, presumably reflecting the need runway capital.

Raising funds for property and capital equipment decreased most significantly in 2020 compared to 2019, whilst property finance has also declined in deal value terms, even though the number of deals is relatively high.

Announced deals: the purpose of funding in 2020 vs. 2019 By number and value

<table>
<thead>
<tr>
<th>PURPOSE</th>
<th>NUMBER OF DEALS IN 2020 SO FAR</th>
<th>PERCENT 2020</th>
<th>NUMBER OF DEALS IN 2019</th>
<th>PERCENT 2019</th>
<th>ANNUALISED CHANGE SINCE 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>RESEARCH AND DEVELOPMENT</td>
<td>220</td>
<td>46%</td>
<td>320</td>
<td>38%</td>
<td>28%</td>
</tr>
<tr>
<td>JOB CREATION</td>
<td>170</td>
<td>36%</td>
<td>362</td>
<td>43%</td>
<td>-13%</td>
</tr>
<tr>
<td>WORKING CAPITAL</td>
<td>45</td>
<td>9%</td>
<td>48</td>
<td>6%</td>
<td>74%</td>
</tr>
<tr>
<td>PROPERTY</td>
<td>15</td>
<td>3%</td>
<td>52</td>
<td>6%</td>
<td>-46%</td>
</tr>
<tr>
<td>CAPITAL EQUIPMENT</td>
<td>13</td>
<td>3%</td>
<td>47</td>
<td>6%</td>
<td>-49%</td>
</tr>
<tr>
<td>PROJECT FINANCE</td>
<td>13</td>
<td>3%</td>
<td>12</td>
<td>6%</td>
<td>101%</td>
</tr>
</tbody>
</table>

Source: ScaleUp Institute Analysis - Announced purpose of funding deals in 2019 and 2020

SECTOR IMPACTS

The impact of the Covid-19 crisis on high growth scaling firms continues to develop, and it is quite possible that the reduction in available external capital worsens before it improves. The true impact of the Covid crisis is still emerging, however we believe that our estimate of an additional cyclical gap of around £7.5 billion per annum is a relatively conservative and early estimate of the quantum of the gap at this time. To help shine some further light on this uncertain Covid-19-related impact, it is useful to consider the sectoral dimension.

The economic impact of Covid on different sectors of the economy has varied to a far greater extent than any previous downturn due to the nature of the blanket lockdown, shielding and social distancing interventions introduced to control the spread of the virus. Hospitality sectors were nearly entirely closed down, while other functions of the economy saw serious operational challenges requiring significant shifts to remote working, online sales models, supply chain disruption, etc., not to mention increased human resource dynamics around sick-leave, furlough and work-life balance having a knock-on effect on productivity. However, underlying demand for many services was not affected to anywhere near the same degree across all sectors (e.g., financial services, utilities, communication). This variation is starkly apparent in estimates of sector GDP (economic output) in Q2 2020, as shown in Figure 8, which compares this to the number of scaleup firms in each sector.

This comparison provides an overview of the relative exposure of high-growth firms to the crisis. There are scaleups in all sectors, including in some of the sectors that were largely closed down in Q2 2020. Some 70% of scaleups are in sectors that were hit hard, but either reopened fairly early (e.g., construction, manufacturing) or could continue to operate through different business models (e.g., online retail, home-working by professionals). However, a significant number are active in the hardest hit sectors (e.g., leisure, entertainment, media and craft industries), which have also experienced a downturn in funding in the first half of 2020 as shown in Figure 9 below.

As we emerge from the Covid crisis it will not be enough to simply recapitalise companies, we will then need to properly support their growth so that they can propel the economic recovery. These proposals set out how government and industry can work together to drive growth and job creation and harness them to the benefit of communities across the whole of the UK.

Miles Celic, CEO of The City UK
UK EXIT FROM THE EUROPEAN UNION

The Brexit decision had an initial significant impact on growth capital funding with the uncertainty impacting on funding in 2016-17 in particular. There is now uncertainty surrounding whether the forthcoming reduction in funds flowing from European Union bodies such as the European Regional Development Fund (ERDF) and European Investment Bank (EIB) / ER and Horizon 2020 will be sufficiently offset by new funding from UK bodies. The impact of the exit from the European Union is also likely to lead to some deep structural changes in the UK economy, requiring new investments in some areas and, inevitably, lost opportunities in other areas.

The overall impact on the growth capital gap is quite uncertain, due to both sides of the equation involving new and lost opportunities, for example:

- The supply of growth capital may be impacted by the loss of funds from European entities, but this could be offset by changes in flows from other markets or new infrastructure within the UK.

- The demand for growth capital may be boosted by new opportunities, but also reduced by some opportunities no longer being viable.

It is clear, however, that the impact must be considered going forward, and is a key part of our thinking for the longer term solutions.

OPPORTUNITIES FROM INCREASED DIVERSITY

It is clear that female and BAME-led businesses are under-represented in the UK high growth firm ecosystem. For example, the Rose Review and work by the British Business Bank, showed that all female founder teams get less than 1% of venture capital (VC) funding, and mixed teams getting only 10%. This suggests that the UK economy is also missing out on a huge pool of talent, and inspiring future female and BAME founders and therefore an extensive missed opportunity for innovation and job creation.

To estimate the impact on the growth capital gap requires an assessment of the potential rate of change in this current dynamic, which depends on the choice of solutions, as well as societal changes, and is beyond the scope of this report. But it is clearly potentially very significant in magnitude, and is a key part of our considerations for the plan going forward.

MEETING THE CARBON NET ZERO CHALLENGE

It has been clear for a while now the massive scale of investment that is going to be required to reduce carbon emissions to a stable level both in the UK and across the world. Recent estimates point to significant investment now being observed in low carbon capital (particularly by electric utility companies) and research and development (particularly by transport companies), summing to some €124 billion in 2019. But this report also concludes that at least double that amount of investment is required across Europe to deliver net zero by 2050.

Clearly the potential need for additional investment in the UK is very considerable, and includes high growth firms across many sectors. Again this is a key area for further research, outside of the scope of this report, but an important element of the plan going forward.

3.3. NEW CHALLENGES AND OPPORTUNITIES GOING FORWARD

There will inevitably be new structural challenges for the UK economy to address which will alter the required flow of growth capital, impacting on both the supply of and demand for that capital.

These changes will therefore impact on the growth capital gap, and while the impact is challenging to estimate (which is why we have not included it in our base estimate of a £5-10bn per annum pre-existing gap), we can explore what some of these issues may entail. In particular, three future challenges that are clear at this time include:

- The structural changes given the UK’s exit from the European Union.
- Addressing the opportunity of improving the diversity of founders and leaders of businesses.
- Meeting the carbon net zero challenge.

We explore each of these structural challenges in turn below.

26 See British Business Bank, ‘UK VC and Female Founders Report’
27 For example, in 2014 the Global Commission on the Economy and Climate estimated a global investment need of US$93 trillion to meet this challenge.
28 For example see Oliver & Wyman, Doubling down: Europe’s low carbon investment opportunity, February 2020.
The Diversity Opportunity

The UK has a rich diversity of entrepreneurship. Supporting our female and black and ethnic minority entrepreneurs to scale their businesses is an immense opportunity for the UK economy.

There have been a variety of reports laying out the challenges for our women and black and ethnic minority led businesses which we discuss further below.

To compound these challenges, all evidence points to the fact that the Covid crisis has had a more severe impact on our female and black and ethnic minority population and is therefore further exacerbating the challenges these entrepreneurs face.

As we seek to build back bolder and better, the levelling up agenda must focus on both regions, localities and diversity with a Blueprint for Growth embracing our diverse culture. It should build on the good work already underway in HMT, British Business Bank and Innovate UK.

In enhancing the roles of the British Business Bank as our National Development Bank or Innovate UK as our Innovation Agency, one of their core public objectives should be to promote diversity and inclusion. The Innovate UK Women in Innovation programme, as well as the new UK Investor Partnership Programme, should include all elements of diversity. There is also opportunity to expand or establish a similar approach for diversity as for the new investing in Women Code supported by HMT and BEIS.

New models of engagement will also be necessary to reach into the networks, forums and investment channels with which women and ethnic minorities engage. Learnings can be taken from the Future Fund deployment to see how it can evolve to increase diversity further and how it can work more closely with specialist private sector players engaged in these sectors. Demographic changes to long-term growth, embracing diversity, must be a key goal for a sustainable economic recovery.

Female Founders

Recent studies and analyses, including the Alison Rose Review of Female Entrepreneurship for HM Treasury, have made recommendations designed to tap the huge unrealised economic potential of female entrepreneurs by making the UK one of the best countries in the world for women to start and grow a new business.

Data highlighted by the Rose Review suggests that up to £250bn of new value could be added to the UK economy if women started and scaled new businesses at the same rate as UK men. Even if the UK were to achieve the same average share of women entrepreneurs as best-in-class countries, such as Canada and the US, this would add £20bn of new value to the UK economy.

The Review found that women do not lack ability or ambition, but only 1 in 3 UK entrepreneurs is female, representing a gender gap equivalent to 1.1 million missing businesses. The Scaleup Institute’s 2020 Female Founder Index revealed that the number of scaleups with at least one female founder is rising. In 2020 we identified 194 female-led/co-led visible scaleups – an increase of 10% in one year – who have raised a total of £585m in 2019.

However, this remains only a small proportion of the total number of 5,456 visible scaleups who raised £1.3bn in 2018 alone.

Female-led businesses are only 46% of the size of male-led businesses on average, in terms of their contribution to the economy. Furthermore, male-led SMEs are five times more likely than female-led SMEs to scale up to £10m turnover.

There are significant differences between male and female founders when it comes to access to finance. According to research by the British Business Bank in 2019, less than 1% of UK venture funding goes to all-female teams and just 4% of deals whereas 89% of the £6bn of venture capital invested in 2017 in the UK went to all-male founder teams. In the FinTech sector, female-led businesses (CEOs and founders) received only 10% of the £4.9bn invested into UK FinTechs in 2019. In the deal flow of the 339 funding deals in the same year.

As such, perceivable barriers within the UK venture finance community are a concern: only 13% of senior people on UK investment teams are female, and almost half (46%) of investment teams have no women at all. Women were also less likely to obtain funding from business angels, only 1% of female founded businesses reporting this as a source compared to 16% of male entrepreneurs.

The Rose Review highlighted three major areas for action: increasing funding for female entrepreneurs via development of a new code for investing in female-founded businesses; new investment vehicles including those with ring fenced funds or targeted rounds; providing family care support for female entrepreneurs by designing new financial products and creating incentives for family care responsibilities; and, making entrepreneurship more accessible for women through realisable and affordable mentoring.

This third element was seen as a major way to break down cultural barriers shared by many women, particularly addressing the lack of confidence in their entrepreneurial skills and limited access to networks. The recommendations proposed by the Rose Review are currently being implemented through the Rose Review Board supported by HMT and BEIS and beginning with the establishment of the Investing in Women Code to which £6 investors have now become signatories, to enable both capturing of gender barriers and improve investment outcomes, as well as the development of a new best practice framework. This is complemented by increased focus on diversity in the products offered by the British Business Bank and British Patient Capital. The Future Fund is encouraging all ventures that have easier access to finance is that the most important support in helping to establish a business – let alone to scale one. Non-financial support was also highlighted as important by both surveys, especially access to mentors.

Of the ethnic minority founders responding to the Extend Ventures and BVCA survey, and only 31% of the businesses had received an equity investment from a business angel or VC, despite two-fifths (39%) seeking this type of investment. A further 18% were seeking grant funding.

In addition, the research found that half (48%) of black and minority-owned businesses surveyed do not plan to access or did not expect to qualify for any government support schemes. This is despite the fact that they were seeing impact from Covid-19 on their client and sales pipelines, cashflow and supply chains.

However, there are a number of additional factors experienced by ethnic minority founders that hinder their ability to start and scale a business, and in particular their resilience at times of economic crisis. Research from the Enterprise Research Centre has shown that these factors include access to start-up funding and insurance, low adoption of ICT within ethnic minority-led businesses, a proliferation of sole traders and/or microbusinesses and that they are less likely to access business advisory and support services.

There is an opportunity to address the gaps that exist for founders from ethnically diverse backgrounds. Alongside addressing the social inequalities that exist for black and ethnic minorities, for example improving access to further and higher education, the government should undertake an awareness campaign to promote and showcase the black and ethnic minority entrepreneurial ecosystem.

Business support providers, banks and other stakeholders should also seek to enhance their understanding of how they can better engage with ethnic minority-led businesses by reviewing and publishing data on diversity which will enable gaps in provision to be effectively identified and targeted solutions developed. The Innovative UK research suggested that such targeted support could be blended in a hybrid model with mainstream programmes to ensure greater diversity and inclusion and address multiple disadvantages.

Recent research from the US has shown that diverse founders returned 30% more capital to their investors at exit – to capitalise on this opportunity and address the finance gap that exists for ethnically diverse businesses, the UK should expand remit of (or establish a similar standard to) the Investing in Women Code to remit of (or establish a similar standard to) the Investing in Women Code to be underrepresented groups in funding decision making. Venture Capital firms in particular should look to the ways they are operating to create greater transparency and openness, through the publication of data, establishing open hours to break down the barriers created by closed networks or developing new scouting systems to source more diverse businesses.

Creating diversity in the investment base

Fewer than one in ten management jobs in UK financial services is held by an individual from an ethnic minority background. Furthermore, in 2019, the FCA estimated that the banking and finance sector won’t achieve gender equality for another 88 years.

Increasing the level of diversity in the equity investment base, including both angels and minority focused VC funds, will be core to closing the finance gaps that exist for female and ethnic minority founders and realising the potential of UK businesses. Actions to increase direct recruitment and integration of more women and members of black backgrounds into existing and new diversity communities will be crucial. Actions should also support and highlight the growing number of angel groups and VC funds that are being led and established by representatives of diverse communities and that are focusing specifically on investing in diverse business ventures, including access to BBA existing venture funding schemes and angel co-investment funds to reinforce the investment capacity, as well as the impact of existing angel and VC investment partnerships. Actions should also support and highlight the growing number of angel groups and VC funds that are being led and established by representatives of diverse communities and that are focusing specifically on investing in diverse business ventures, including access to BBA existing venture funding schemes and angel co-investment funds to reinforce the investment capacity, as well as the impact of existing angel and VC investment partnerships. Actions should also support and highlight the growing number of angel groups and VC funds that are being led and established by representatives of diverse communities and that are focusing specifically on investing in diverse business ventures, including access to BBA existing venture funding schemes and angel co-investment funds to reinforce the investment capacity, as well as the impact of existing angel and VC investment partnerships.
3.4. Scaling the Economic Significance of the Growth Capital Gap

There is a body of literature on how venture capital and business angels help to foster the investments of start-up and scaleup companies, and consequently drive job creation and economic growth. For example, a 2015 European Commission report assessed how tax incentives can support the important role of growth capital in this regard[29], concluding that ‘venture capital and business angel investment has been shown to generate a number of positive macroeconomic effects, such as job creation and productivity gains’. There is a wide acceptance that investment in growth capital produces multiplier effects that justify tax incentives.

To provide a further lens on the growth capital gap, it is also useful to consider the scale of the gap compared to other high level indicators of economic activity. This provides insight into the potential economic impact of closing the growth capital gap, both in terms of a gross impact (e.g. job creation) and also longer term net impacts (e.g. impact on UK productivity). With the expectation of significant unemployment in coming months, the gross impacts are arguably as important as the longer term net impacts, at this time.

Regarding the gross economic impacts, we observe that closing the growth capital gap would represent:

- A potential 10-20% boost to UK business investment (£200bn in 2019[30]), which is a positive impact that is a similar order of magnitude to the current consensus forecast on the potential negative impact of the Covid-19 impact in 2020[31].
- Increasing growth capital funding to high growth companies by c.20% per annum leading to increasing accumulation of high-growth firms over time, potentially doubling the number of scaleup firms over a 5-10 year period.
- Potentially creating around 3 million new jobs over time, during a period where unemployment is expected to be sharply increased. Scaleups employed some 3.5 million people in the UK in 2018.

In the longer term, the net economic impact of policy action is likely to be driven more through overall productivity improvements, rather than gross amount of employment, investment etc. In terms of net impacts, we observe that close the growth capital gap would likely:

- Assist the levelling-up objectives delivered through strong growth across all regions, not just London and the small number of other regions that currently have a sufficient scale and depth in terms of growth capital funding. Our analysis above points to a large numbers of currently unmet growth capital opportunities recorded across all regions.
- Increasing the scaleup population would be consistent with driving incremental long-term economic growth, as their productivity has been found to be systematically higher than other companies across all sectors of the economy. The scaleup productivity premium was estimated to be 54% in 2018 – meaning that scaleups are, on average, 54% more productive than similar firms in the same sector. See Figure 10 below for further analysis from the ScaleUp Institute.

The existing literature on growth capital investment and these estimates provide a compelling case for further supporting growth capital in the UK. Further analysis of the potential economic impact of supportive policies can be expected to show strongly supportive multipliers for government intervention.

The Growth Capital report gets to the very heart of the problem facing early stage and scaleup businesses in the UK in the face of the coronavirus pandemic, namely the chronic lack of equity funding available to such businesses across all of the UK, but particularly in the region. The report zeroes in on why equity funding is so important and sets out a coherent plan for expanding existing schemes alongside new, innovative funding ideas to help UK scaleups realise their ambitions and deliver desperately needed growth to the UK economy.

Mark Brownridge, Director General, EISA

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29 European Commission, ‘Effectiveness of tax incentives for venture capital and business angels to foster the investment of SMEs and start-ups’, 2015.
30 ONS data
31 The consensus forecast for fixed investment growth in 2020 was 15.5% in July 2020, as surveyed by HMT in ‘Forecasts for the UK economy: a comparison of independent forecasts, July 2020’.

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“The Future of Growth Capital Report”

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Figure 10: Scaleups are more productive than the UK average across every sector

<table>
<thead>
<tr>
<th>Sector</th>
<th>Scaleup Productivity Premium</th>
<th>UK Average Productivity Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education</td>
<td>55%</td>
<td>15%</td>
</tr>
<tr>
<td>Professional, scientif &amp; tech</td>
<td>66%</td>
<td>16%</td>
</tr>
<tr>
<td>Construction</td>
<td>67%</td>
<td>20%</td>
</tr>
<tr>
<td>Creative / Arts</td>
<td>71%</td>
<td>24%</td>
</tr>
<tr>
<td>Agriculture</td>
<td>75%</td>
<td>28%</td>
</tr>
<tr>
<td>Agri/M ining/ Ener gy/Water</td>
<td>78%</td>
<td>31%</td>
</tr>
<tr>
<td>Health/Social Work</td>
<td>87%</td>
<td>36%</td>
</tr>
<tr>
<td>Other Service Activities</td>
<td>141%</td>
<td>44%</td>
</tr>
<tr>
<td>Transport</td>
<td>161%</td>
<td>48%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>164%</td>
<td>52%</td>
</tr>
<tr>
<td>Other Service Activities</td>
<td>166%</td>
<td>54%</td>
</tr>
<tr>
<td>Wholesale/Retail</td>
<td>161%</td>
<td>56%</td>
</tr>
<tr>
<td>Wholesale/Trade</td>
<td>164%</td>
<td>58%</td>
</tr>
<tr>
<td>Construction</td>
<td>164%</td>
<td>60%</td>
</tr>
<tr>
<td>Transport</td>
<td>166%</td>
<td>62%</td>
</tr>
</tbody>
</table>

Productivity of scaleups relative to the sector average


Together with the ScaleUp Institute, we’ve long been extolling the transformative effect of investment on business growth. The numbers in this report show how much investment is required to enable business growth across the UK – growth which is needed now more than ever. The amounts are not small but they are achievable. SMEs are an excellent asset class that deliver returns to investors, jobs to the economy and innovation to society.

Henry Whorwood, Head of Research & Consultancy, Beauhurst
The UK is not the only economy considering the need for growth capital to drive the success of high growth firms and economic prosperity. In a dynamic global landscape, many countries and regions are turning their attention to scale-ups as a means of economic renewal such as the recently announced start-up investment fund in France (see panel).

In 2019, France announced €5 billion of investment capital being made available for French start-ups over the next 3 years, with the President setting a goal of France having 25 unicorn companies by 2025, and attracting more capital from overseas.

Of the €5 billion announced, €2 billion will focus on late-stage investments, whilst €3 billion will support global tech funds managed by French-based managers. This investment capital will be made up of two-thirds private companies and one-third public institutions such as the pension reserve fund and EDF.

As a consequence, the amount of investment capital available to French tech companies has tripled over the last four years, putting France ahead of Germany in terms of stage investments, whilst €3 billion will support global tech funds managed by French-based managers. This investment capital will be made up of two-thirds private companies and one-third public institutions such as the pension reserve fund and EDF.

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All this aligns with the French government’s mission to provide French start-ups with global opportunities to scale - known as The French Tech Mission, or La French Tech.

Under the leadership of French President Emmanuel Macron, the tech ecosystem in France continues to benefit from both public and private capital support.

I am delighted that the Business Action Council have demonstrated the benefit of a collaborative ecosystem by coming together with others to deliver such a valuable report. It’s vital that we work together on these issues and provide the consensus from enterprise that will help this administration deliver the right support at speed – so that it is effective, sustainable and instils confidence.

Access to Growth Capital is crucial and this report provides important evidence and clear recommendations on how this can be taken forward at a critical time for the UK economy. As an entrepreneur, I believe in the importance of scale-ups, which are frequently our most innovative businesses and are thus essential for the UK’s recovery from the crisis.

Maurice Ostro, Chair of the Business Action Council
We draw a number of key learnings from the success of KfW as a development bank, which informs our thinking on key recommendations. These include:

- Leveraging a strong regional network, deployed under a national framework, allows KfW to work locally with banks to offer more favourable loan schemes for local investment, whilst benefiting from the existing relationships. While creating such a network in the UK would likely take considerable time and effort, this example points to benefits in developing a national framework to make best use of what we have, and potentially moving to address some of the most pressing gaps.

- KfW shows that state-supported development banks can make a major impact, which points to further bolstering the development banks that the UK already has in place: the British Business Bank, the forthcoming Scottish National Investment Bank, the Development Bank of Wales and Invest NI.

- The success of KfW Capital in providing state-supported capital bolstering venture capital investments for early stage financing, points to another aspect of the model that may be relevant to the SBA and the UK.

- The provision of capital to small businesses, provides business counsel or entrepreneurial development services, and supporting the awarding of government contracts to a defined statutory target level, 23% of federal contracts by value awarded to small businesses.

- The SBA provides an opportunity for institutional and corporate funding to access a larger pool of institutional funds. Participating companies issue bonds with some common characteristics but for different amounts. The individual bonds are grouped together under a securitisation transaction structured by an independent financial institution with a Special Purpose Vehicle issuing the Basket security through ELITE to institutional investors.

We draw a number of key learnings from the success of the Canadian pension schemes, which informs our thinking on key recommendations. These include:

- While changes in legislation are clearly required to help unlock institutional and corporate funding in some areas, particularly regarding DC pension schemes, to help increase the impact of major DB pension schemes the supply of growth capital is likely to require longer-term cultural change as well. The Canadian pension model has evolved over time, particularly with regard to developing highly professional in-house investment decision-making, and this would take time to replicate.

- But even with the focus on competing for the best talent in terms of asset management, the Canadian pension funds continue to cooperate with one another in terms of co-investments, due to the significant benefits of doing so. This helps them manage their exposure to individual projects or businesses, which is a key risk for all DB pension schemes in particular. Canadian or UK alike.

This highlights both the potential benefits of the Canadian model as well as the considerable challenges to unlock the vast sums, particularly on the DB side. In the shorter term, unlocking the DC funds may be a more attainable goal.

### CANADIAN PENSION SCHEMES

Like the UK, the Canadian occupational pension system includes a mixture of (mainly public sector) defined benefit schemes and (mainly private sector) defined contribution schemes. Among the DB schemes, there are a number of large provincial schemes that are widely considered to be global ‘best practice’ organisations, including, for example: the Canada Pension Plan Investment Board (CPPIB), the Caisse de dépôt et placement du Québec (Caisse) and the Ontario Teachers’ Pension Plan Board (OTPP), along with various other provincial mainly public sector pension schemes. The country’s top 10 public pension organisations manage over $2.3 trillion in assets, employing thousands of highly qualified professionals, and competing for investment opportunities around the globe on behalf of Canadian pension beneficiaries.

Over the past three decades, a ‘Canadian model’ of public pension has emerged that combines independent governance, professional in-house investment management, scale and extensive geographic and asset-class diversification. It primarily focuses on diversifying in illiquid, alternative asset classes, such as, infrastructure and real estate, with a preference for direct investment. Some schemes, such as OTPP, have actively entered into venture capital, for example with the launch of the Teachers’ Innovation Platform, which makes late-stage venture capital and growth equity investments. The main distinction for the purposes of the report is the much greater extent to which Canadian pension schemes have brought on board highly competent in-house investment professionals to directly make investment decisions. Roughly three-quarters of the assets of the top ten Canadian pension funds, across a range of asset classes, are internally managed rather than managed by external asset managers. While the pension funds compete for talent, they do also commonly co-invest in businesses and projects, to help share investment risk on deals.

The SBA provides another example of a national framework for addressing capital issues for small businesses. Over the past three decades, a ‘Canadian model’ of public pension has emerged that combines independent governance, professional in-house investment management, scale and extensive geographic and asset-class diversification. It primarily focuses on diversifying in illiquid, alternative asset classes, such as, infrastructure and real estate, with a preference for direct investment. Some schemes, such as OTPP, have actively entered into venture capital, for example with the launch of the Teachers’ Innovation Platform, which makes late-stage venture capital and growth equity investments. The main distinction for the purposes of the report is the much greater extent to which Canadian pension schemes have brought on board highly competent in-house investment professionals to directly make investment decisions. Roughly three-quarters of the assets of the top ten Canadian pension funds, across a range of asset classes, are internally managed rather than managed by external asset managers. While the pension funds compete for talent, they do also commonly co-invest in businesses and projects, to help share investment risk on deals.

The SBA is a US government federal agency that provides support to entrepreneurs and small businesses. It was created in 1953 as an independent agency of the federal government to assist and protect the interests of small business concerns. It has a network of offices across the US that process loans, provide disaster assistance and business development services.

Like the KfW, the functions and role of the SBA is governed by law, with its three main functions being, the provision of capital to small business, provide business counsel or entrepreneurial development services, and supporting the awarding of government contracts to a defined statutory target level, 23% of federal contracts by value awarded to small businesses.

The SBA has total assets of $12.7bn and an outstanding loan portfolio of $124bn. The main tool for supporting SMEs is the 7(a) loan guarantee programme, which accounts for 63% of the SBA’s loan portfolio. These loans are targeted at small businesses which are unable to apply for commercial loans and are provided by lenders that have partnered with the SBA, which include most major American banks as well as local and state banks. The SBA guarantees up to 85% of loans up to $150k and up to 75% on loans up to $5 million, providing loans with long maturities, ranging from seven to ten years, reaching a maximum of 25 years when the investment is used to purchase fixed assets or real estate with a long-term useful life.

Governmental interest in the SBA’s loan, venture capital, training, and contracting programs has increased in recent years, as small businesses are viewed as a means to stimulate economic activity and create jobs, particularly in the context of Covid-19.

We draw a number of key learnings from the success of the Canadian pension schemes, which informs our thinking on key recommendations. These include:

- There are benefits from the long-running state-supported lending programme for the smallest businesses, including its adaptability for times of crisis.

- Like the KfW, the system benefits from a central body with a network of regional delivery models, in this case primarily through the banks.

The SBA provides another example of a national framework for addressing capital issues for small businesses at a local level, which is a key requirement this report seeks to address.

### SMALL BUSINESS ADMINISTRATION (SBA), USA

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### ELITE, LSEG ITALY

ELITE is LSEG’s private market, connecting private companies to diverse sources of capital to drive their growth. ELITE’s network and platform provide companies with simplified access to a range of funding options, help intermediaries and brokers expand their reach, and direct the impact of institutional and professional investors to the real economy.

In addition to facilitating single company transactions, ELITE has the flexibility to support clusters of companies through its Basket Bond product, which was launched in 2017. The Basket Bond provides an opportunity for institutional investors to support growing companies while maintaining a portfolio approach and gives companies access to a larger pool of institutional funds. Participating companies issue bonds with some common characteristics but for different amounts. The individual bonds are grouped together under a securitisation transaction structured by an independent financial institution with a Special Purpose Vehicle issuing the Basket security through ELITE to institutional investors.

Over the years, ELITE has launched several Basket Bonds in Italy each with a specific focus (for example regional such as those launched in Lombardia and Campania, or exports etc). Creating a specific theme for the Bond generates targeted interest from both companies and investors and provides the opportunity to seek government or institutional support. For example the ELITE Export Basket Bond launched in 2019 was guaranteed by SACE (the Italian Export Credit Agency). Additionally, there is flexibility to create a Basket Bond programme which can then be accessed in tranche by smaller groups of companies over a number of years.

In light of the challenges faced by smaller Italian banks particularly during the Covid-19 crisis, ELITE has also launched a Basket Loan programme supporting smaller banks with standard procedures and tools to help them provide and aggregate SME loans. Similar to the Basket Bond for the Basket Loan individual company loans are aggregated through a securitisation process with the guarantee of the Central Guarantee Fund of the Italian Government. This initiative is with a small number of banks that have the balance sheet capabilities but not necessarily the tools and risk appetite to lend to a larger number of individual SMEs.

The ELITE Basket products could be a relevant solution for UK SMEs which should be investigated further with companies and investors. In the UK context, baskets could be tailored around innovation, sectors such as manufacturing, regions etc. Additionally, there may be opportunity to explore baskets for other underlying securities (for example equity).
5. RECOMMENDATIONS IN DEPTH

A number of solutions have been evaluated across the market failures - see grid below - and these have been assessed across four classifications of:

• Accelerate the pillars that already exist
• Expand to meet the key challenges
• Realign in response to the changing opportunities post-Covid-19
• Create new long-term infrastructure to drive growth

Overall these varying solutions and levels theme into 5 key actions which will materially affect the structural and cyclical growth gap:

KEY RECOMMENDATIONS

Five key actions will materially affect the structural and cyclical growth gap.

1. CREATE A ‘NATIONAL BLUEPRINT FOR GROWTH’

Create a ‘National Blueprint for Growth’ that delivers a strategic joined up approach to support and champion more consistent and effective growth across all regions and sectors of the economy. Using a strategic, tailored and segmented approach to scaling businesses that addresses the UK’s systemic issues around scaling up across talent, markets and infrastructure, develop a core long term growth capital strategy to tackle regulatory, legal and structural impediments and identify related short-term tactical opportunities.

The UK’s lies 13th in the world for ‘scaleups’ and when compared to our international counterparts that lay ahead of us, including France, Germany, US and Canada, it is clear that common features they share are: a more federated ‘regionalised’ governance model; long term ‘arms length’ national agencies driving their finance, innovation and business support interventions; deeper pools of capital drawn from the institutional private sector, across varying asset classes, including in a number a Sovereign Wealth Fund.

As we head further into a new decade, which has brought with it an unprecedented global pandemic, and seek to recover and build back better, the UK must definitively tackle the long term structural deficiencies in scaleup growth and the key impediments to it which include access to long term patient capital.

A new National Blueprint for Growth should have 3 key underpinning elements:

i. High Growth Segmentation: developing and embedding a joined up strategy across business growth life cycles with tailored solutions across national and local government. This should place scaling business, new and established, across sectors, at its core. It should break down silos and departmental barriers to ensure there is a clear cross government scale up strategy with dedicated resources and relationship management structures at local and national level to back delivery to address:
   - Scaleup talent needs across sectors and geographies, including fast track visas.
   - Scaleup market needs: procurement, collaboration

ii. Realignment of the regulatory and policy environment towards growth by reassessing the legislative and regulatory impediments to growth removing barriers and championing innovation, in particular addressing the long term impediments to Growth Capital. This realignment should focus on:
   - Driving up the R&D opportunities by taking a bolder approach to the Frascati Manual and assessing the R&D tax credits to encompass all sectors. This could include a temporary bringing forward of R&D tax credits as we kick start the recovery
   - An enhanced AIA for scaling firms to support capital investment
   - Broadening of Sandbox opportunities across regulated sectors
   - Growth Boards established at regional level to drive forward local initiatives
   - Reassessing State Aid rules and UK legislation hindering growth opportunities and growth capital flows - see Recommendation 2 below.

iii. Open Data:

   The power of data to better understand and boost economic growth is significant. Understanding our economic health demands frequent taking readings at many levels with existing and new data, and better ways of combining it. Harnessing public and private sector data is key as we seek to refine and target initiatives and engagement towards scaling businesses in a timely and effective manner. Government should make sure that legislation supports data sharing across departments and localities, including that held HMRC that has the most up to date data points. Open data sources such as Open Banking should be leveraged along with APIs and the continuation of the Government DECA project. Better use of data held will support the levelling up agenda, makes the ecosystem more efficient in their assessments and solutions and enable prioritisation of those areas of the country where the scaleup gap is increasing as well as target bespoke engagement with our scaleup high potential growth firms.

2. ACCELERATE THE UNLOCKING OF INSTITUTIONAL AND CORPORATE FUNDING

Through changes in legislation and organisation that crowds in the existing significant private sector capital flows can make their way into closing the Growth Gap. This should entail developing an aggregator structure with relevant back office analytical and distribution capability. Such a structure could be pursued by transforming British Patient Capital (BPC) into a joint-venture vehicle with the private Sector. The Government would deploy further seed capital as necessary. Their role in this is to convene and catalyse, with the private sector crowding in around it.

Institutional entities such as pension funds, insurance companies and corporate entities are key to closing the Growth Capital Gap and their resource pools must be unlocked in order to do so.

The annual flow gap of £35bn identified in this report is equivalent to only a fraction of a per cent of total UK pension fund assets under management. With the right structures in place this is well within the grasp of the UK private sector to close with relevant regulatory support and impetus from Government which needs to do more to scale down and accelerate key measures underway and drive forward heightened collaboration with the private sector.

The Patient Capital Review (PCR) clearly laid out the analysis of the issues surrounding release of such capital pools and it also laid down a pathway of action to begin to tackle this which remain even more valid today.

The key now is to significantly up scale at the progression of these initiatives as well as deal with the regulatory impediments including revisiting Solvency II.

As reflected below there has been action taken on the majority of the PCR recommendations e.g establishing British Patient Capital (BPC), re-focusing EIS and VCTs on knowledge intensive funds and implementing a regional Angel programme through the British Business Bank.

However, most initiatives are only part way to being fulfilled and currently sub- scale to meet the full structural challenges in play - yet alone the now significant Covid-19 cyclical challenge.

For example, the £2.5bn British Patient Capital programme, and the additional £5bn it is looking to unlock from the private sector, is in year two of a 10 year investment programme; with so far only £34m in new BPC funded commitments in 2018/19. On a regional level, the £100 million Regional Angel Programme that was announced as part of the same package of measures is at an early stage of deployment and has only deployed 30% of the funds in the first 2 years. VCTs are still hampered by rules that

Caroline Norbury MBE, CEO, Creative England and Creative Industries Federation
limit their follow on funding ability with existing portfolio companies which necessarily impedes the ability for businesses to scale with their existing investor base.

Blockers also remain to fully unlock institutional investment, particularly from Pension Funds. Whilst some changes have been made following recommendations by the Pension Taskforce, further progress still needs to be made on both the technical assessment of changes to fee structures, as recommended in the DC Pensions review which reported in September 2019, and to develop better vehicle that enable the industry to access high growth business asset class.

The current acute challenges created by covid-19 mean it is even more important to take bold action to address both the structural and cyclical challenges that the UK economy faces. With the gap now doubling, a heightened impetus and focus is required to allow the UK economy to move forward to recovery.

The Government needs to rapidly accelerate the delivery of the suite of PCR initiatives, with injection of both further seed capital as well as impetus to deliver the required regulatory changes.

To catalyze action, Government should in the forthcoming CSR invest further through the BCP structure and at the same time seek to accelerate its partnership (move towards) with the private sector by forming a much more structured relationship with the BCP and the private sector, in a more formal Joint Venture type arrangement with private sector institutional and scalable funds, where it can leverage both institutional monies, analytical and distribution power. Lessons can be drawn from the Canadian models on such an arrangement which fosters collaboration and cooperation, please cross reference with page 38, Canadian Pension Schemes.

Such a Joint Venture arrangement would provide the aggregator structure desired by the institutional players at the same time as delivering at scale regional funds with more ready access to investor pools. There are a range of UK private sector Funds that could be harnessed to form part of the Venture such as ForeSight, BGF, Mercia, Minerva etc. Leveraging also the structures that have evolved through e.g. NPIF/Midlands/WvD/SNI and that require evolution in other regions. From an institutional standpoint the BCP with such a formation would provide the aggregator vehicle desired by institutional players and at scale distribution. Whilst regulatory measures can be developed to encourage investment through such a vehicle in parallel relevant co investment and guarantee structures should be deployed to support institutional and corporate engagement with BCP. This should include the immediate progression of the Small Business Investment Company model identified in the PCR.

Collaboration will be key going forward. Fully implementing the PCR at pace is essential. We have the ingredients - they need to come together, be fully implemented and be supported by regulatory changes.

The Government has a role to catalyze that collaboration and the private sector a role now to step up and work with the public sector to add the significant issues growth capital issues Covid-19 has exacerbated if we are to harness our entrepreneurial strengths and scaleup films for the next generation.

3. EXPAND AND BUILD UPON THE BRITISH BUSINESS BANK (BBB) AND OUR DEVOLVED NATION DEVELOPMENT ENTITIES

Expand and build upon the British Business Bank (BBB) by creating greater regional presence, with regional decision making, of the BBB deployed under a national framework and continue the developments with Scottish Investment Bank, Development Bank of Wales and Invest NI. Develop, through this presence, empowered regional and devolved hubs with the ability to agile and deploy funding to sectors and opportunities at speed, through both national and bespoke, regionally designed schemes. Increase the BBB and devolved development entities capacity and runway to respond to the economic changes Covid-19 and the exit from the EU bring. Expand existing programmes and develop new ones as economic and sector needs evolve.

Regional Presence - learning from others

The intent of this model is to combine local knowledge and insights with the British Business Bank’s expertise to deliver local solutions at a commercially viable scale - as scale will be vital for success.

Taking learnings from international players, the BBB’s role as a National Development Bank should retain an arm’s length relationship with Government, allowing it to focus on day to day operations and allocating resources where it sees market needs, while working to a clear and defined set of long-term objectives that are agreed with government, with devolved entities operating on the same basis.

The BBB would continue to act primarily as a wholesale funder and ecosystem developer.

Similar to the private sector, alongside the existing National Hq, going forward the BBB would strengthen its network presence in regions which could include the set up of formal regional offices. These could have ring fenced resources operating to defined parameters and budgets set at BBB national level. An enhanced regional presence would bring it closer to the market place and to the end customer and will enable it to respond rapidly to emerging regional needs and themes. Such presence would also reduce the friction of local investors ability to access schemes in a timely manner with these BBB regional centres/hubs, similar to the private sector, holding delegated authority to approve investors fitting the criteria set for participating in schemes set at national level. This enhanced regional network could also be allocated a portion of funding as a Local Opportunity Budget for use on new local initiatives pertinent to the region and matching pertinent criteria set at the outset. BBB regional offices could be firstly established in significant regional clusters whilst at the same time, exploration technological solutions to increase local reach should be made. Relevant learnings from from the Future Fund should be leveraged.

Expansion / Acceleration of existing products

In addition to this expanded local presence with delegated powers, the BBB should assess the suite of products now in its armoury and seek to scale up, accelerate and expand those with proven results. This would include expanding the Angel Co-Fund, accelerating deployment of the Regional Angel Programme, expand the ECF programme and expansion of the activity of Regional Investment Funds; both to extend runways of existing mechanisms such as the Northern Powerhouse Investment Fund, Midland Engine Investment Fund and expand into areas not yet covered, e.g. West of England/South West. It should also assess models working elsewhere and adopt them where proven and relevant including the Scottish Angel Co-investment Fund model to widen access to co-investment opportunities.

In particular the capacity for UK Venture Debt should be fostered working with the private sector. In this regard, HMT should work with BBB to build on the success of the Future Fund to expand its life span and reach.

Tackling Information Asymmetries and Diversity

A key role for an enhanced BBB regional presence would be to devise strategies to mitigate information asymmetries through outreach activities with the investor, bank, advisory and business communities, building on the current role of the BBB UK network team. This will also aid in addressing the information asymmetries through structured education activities; investor briefings and intelligence gathering. It should also facilitate a stronger cluster effect, which is beneficial to local growth, and be a driver of connectivity between regions and national private sector players.

The offices should also have a specific Diversity objective and role to work with Diverse community leaders in extending the reach of finance to women and BAME entrepreneurs.

The BBB Finance Hub should be expanded to include greater levels of localised information, and potentially play a role in an equity referral mechanism working with the private sector, such as the ELITE platform (see International Learning).

In time the BBB and devolved nations development entities could also be a means through which to deliver the Shared Prosperity Fund at a local level. There is also a potential case for UK-wide elements of the BBB and Devolved entities as in other markets, such as Germany, where export services sit under KfW.

4. EXPAND THE SCALE AND ROLE OF INNOVATE UK AS OUR NATIONAL INNOVATION AGENCY

Expand the role and scale of Innovate UK and its direct deployment of innovation & R&D investment capital (via grants and loans through their Investor Partnership Model), to our most innovative, early stage and scaling businesses. Expand Innovate UK’s (UK) high growth regional relationship management infrastructure and global innovation network, along with the critical partnership opportunities it brings to our scaleups in collaborating with Government, corporates and Universities. This should include expansion of the role and use of SRRI including its ability to drive procurement with scaling firms and Government as an anchor ‘first’ client, strengthening the Catapult Centres to support regional clusters and further drive forward R&D investment via Test beds and technology focused competitions.

Innovative businesses are a key part of growing the UK economy. Innovate UK has an important role to play in driving this agenda and ensuring more innovative UK businesses go on to grow and scale in the UK and globally.

However, there are a number of challenges which must be addressed to ensure a strong recovery and future economy which enables the UK to compete with other countries. Firstly, the need to increase the level of R&D investment from the public and private sectors - the Government’s intention to increase public investment in R&D to £22bn per year by 2024/25 is an important statement of intent. It is also essential that the UK takes steps to maximise the opportunity to have a recovery that supports green growth. Furthermore, in order to support our innovative, scaling businesses to grow globally we need to maintain access to, and develop new links with, programmes in Europe and beyond that enable international collaboration and supply chain access, for example Horizon Europe.

To be seen as a global leader in innovation, the UK has to develop unique capabilities and facilities that are world leading and therefore an attractor of global research talent and businesses to come to the UK. It is important to anchor these in a strong and effective innovation agency. Building on what works and taking action to strengthen Innovate UK’s ability to deliver tailored support, programmes and funding to businesses that maximises their growth is vital. Increased partnership with the private sector is also important, both for leveraging private investment, but also to maximise the knowledge and expertise that exists and bring them together for the benefit of the business.
A range of key opportunities emerge for Innovate UK to expand its remit to boost growth: these include:

A broader interpretation of the Frascati Manual: As we move forward with the R&D roadmap, as laid out in the Government’s recent publication, we should take the opportunity, as part of a National Blueprint for Growth as outlined in recommendation 1, to reorient the manner in which we are implementing the Frascati Manual to ensure it optimises growth and R&D opportunities.

Funding and finance – extending the investor Partnership Programme – Innovate UK funding is often seen by the investor community as a “quality badge” and helps crowd in private finance where R&D is deemed too risky or early stage for private investment alone. To ensure more private investment is crowded in, Innovate UK’s Investor Partnerships model could be expanded, offering a package of public sector grant funding and private equity Investment to support early stage R&D and accelerate the process of commercialisation. Evidence shows that businesses that secure both grants and equity tend to raise more money and achieve higher valuations than their counterparts who secured either grants or equity. As at July 2020, £25.8m in grant funding has been committed to 121 SMEs alongside £68m in aligned equity investment from 21 investor partners. 37 projects have completed. Over £188m in follow-on investment has been raised by SMEs involved in these programmes (excluding one outlier raising a further £67m).

Innovate UK’s wider portfolio of grants, loans and SBRI procurement contracts is also vital for many businesses and the level of funding needs to be increased as well encouraged greater use of SBRI by other Government Departments and public bodies.

Testbeds – Large scale testbeds should be funded in areas to enhance the internationally recognised local strengths to raise the profile of R&D and innovation and drive forward UK industry and new sectors of the economy, level up regional economies; attract inward investment and talent and drive the scaleups of tomorrow.

Catapult centres – there is the potential to strengthen the existing network of Catapult centres and create new centres in areas where the UK has the potential to take a global lead and to support UK industry to do so. Given the centres are located in different parts of the UK there is also the opportunity create more of a ‘cluster’ effect around them and collaborative opportunities as a route to anchor clients in the public and private sector.

ScaleUp Network – It is important to build on the success of the existing Enterprise Europe Network and create a new network focused on innovation and global growth to support innovative high growth and scaling businesses in the UK. Currently the network supports over 3,000 businesses each year, bringing together a coherent package of support including 250 Innovation and Growth Advisers across England, Northern Ireland and Wales (with Scottish Enterprise covering Scotland). A ScaleUp programme using a novel delivery model provides high end intensive support to a select group of c40 companies with the highest growth potential each year. This should continue to be enhanced and developed including its peer to peer activity.

5. Creation of a ‘future opportunity fund’

A dedicated Future Opportunity Fund should be developed to allow the UK to effectively engage with emerging sectors and industries such as the carbon net-zero challenge as well as drive forward on wider sustainable goals.

This would be ‘purpose driven’ and have the right risk appetite to seed and catalyse long term UK economic growth from nascent and developing sectors, and opportunities which are yet to emerge.

This fund would be designed to work actively with the overarching growth blueprint set out in Recommendation 1, and the broader enhancements described in wider recommendations.

It could sit as part of a number of existing bodies such as Innovate UK and the British Business Bank. International models often have such a mission led under the wing of the Innovation Agency or National Development Bank. Alternatively, it could be standalone and operate as an entity with the dual role of not only supporting domestic companies but international opportunities similar to a Sovereign Investment Fund. This would allow it to have both a domestic and international role taking significant positions in sectors addressing global challenges.

To be effective, this fund must also be flexible enough to account for the evolving nature of these future opportunities and actively work to engage with the data to find them.

Innovative and new industries have significant risk profiles and can be challenging for investors to engage with, even when the development of such industries will have long term material benefits to the UK and global economy as a whole.

Building upon previous examples the purpose driven nature of such a fund will be key in enabling wider investment to industries of fundamental significance, and in line with UK economy wide goals of job creation, levelling up and local economic growth.

The Future Opportunity Fund would represent an active tool that takes measured and recognised risks, as well as facilitating the mobilisation of private sector capital into key emerging global industries that are of strategic importance to the UK.

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<th>MARKET FAILURES</th>
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<tr>
<td>1. Uncordinated approaches created regulatory barriers which impede the flow of funds.</td>
<td>Accelerate the implementation of the Patient Capital recommendations incl. enacting regulatory changes crewed in relation to IC/Pensions alongside registration of expanding VCT funding (e.g. company age, investment thresholds)</td>
<td>Expansion of FCA regulation and digital Sandbox in addition to Open Banking, to include an investment component and ensure participation in the sandbox addresses key challenges around support for customers affected by Covid-19; further access to finance for SMEs, and solutions to help prevent fraud.</td>
<td>Review tax incentives for EIS/SEIS, VCTA new state-aided funds to invest in key stages companies with lower tax relief to attract institutional funding.</td>
<td>Advance R&amp;D tax credits and implement EIS/STIC reform.</td>
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<td>2. Inefficient depth of funding and capacity, including scale and resource pool in the regions beyond London and the South East</td>
<td>Accelerate deployment and wider access to BBI Regional Angel Programme</td>
<td>Address the leveraging up-agenda by replicating the success of the Midlands Engine and Northern Powerhouse funds to other regions.</td>
<td>Central Government resources to regions</td>
<td>Better/more diverse distribution channels to ensure funds can be accessed across the UK.</td>
</tr>
<tr>
<td>3. Lack of scale and depth in follow-on funding due to limitations in current range of funding mechanisms</td>
<td>Patient Capital Investment Company (PCIC) programme</td>
<td>Replace the age limit with a gross assets test to expand eligibility of State and Risk Finance (SBIA)</td>
<td>Central Government resources to regions</td>
<td>Regional BIF physical offices aligned to key regional hubs, with devalued powers to tweak core initiatives to regional needs and take learnings from IFCC.</td>
</tr>
<tr>
<td>4. Information, Collaboration and Connectivity Asymmetry</td>
<td>Accelerate the deployment of Government High Growth teams in every development stage of later stage account managers targeted by growth sectors, regions, product</td>
<td>Develop regional funding ecosystems to build on the Future Fund to create an equity component and ensure participation that targets specialists or industries and encourages a clustering effect.</td>
<td>VCT Growth fund and other specific co-investment funds, e.g. creation of new state-aided funds to invest in key stages companies with lower tax relief to attract institutional funding.</td>
<td>Equity referral mechanism taking learning from SBA credit sharing and offset referral processes.</td>
</tr>
</tbody>
</table>

The Future Opportunity Fund would be key in enabling wider investment to industries of fundamental significance, and in line with UK economy wide goals of job creation, levelling up and local economic growth.
**ADDRESSING THE ‘CYCLICAL’ GAP: PROPOSED SOLUTION**

<table>
<thead>
<tr>
<th>MARKET FAILURES</th>
<th>ACCELERATE</th>
<th>EXPAND</th>
<th>REALIGN</th>
<th>CREATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>5. Growth capital flows are not sufficiently resilient and flexible through this crisis</td>
<td>Expand scale of BBB, IUK and products therein</td>
<td>Enshrine BBB/IUK and Growth hubs in legislation for long term with agreed minimum 10 year funding cycle</td>
<td>Creation of sovereign wealth funds with long term scaled funding that focuses on the domestic and international agenda</td>
<td>Government to directly subsidise investments in mid-sized firms that otherwise will struggle to raise equity or that support specific strategic objectives</td>
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<tr>
<td>6. Increased uncertainty and reduced risk tolerance of investors limits interest in new opportunities</td>
<td>Review State Aid risk-finance guidelines to enable relevant time-bound EIS/SEIS adjustments to stimulate additional Angel and HNW investment</td>
<td>Protect against macro-economic tail risk - get some offset through insurance premiums in advance</td>
<td>Incentives for pooled investment vehicles, including corporate venturing</td>
<td></td>
</tr>
<tr>
<td>7. Government supported crisis liquidity support inadvertently crowds out growth funding or working capital sources</td>
<td>Boost role and capacity of private investors to provide support and capital through EIS/ISA incentives for which the UK is in a strong position</td>
<td>Expand InnovateUK grants and innovation loans which are a cornerstone to scaling growth and crowding in private sector investment</td>
<td>Establish London Stock Exchange as the leading pan-European market for scaleups</td>
<td>New capitalisation vehicles to support the economy and clean up banks’ balance sheets by setting up a ‘bad bank’ to facilitate with other government initiatives</td>
</tr>
<tr>
<td>8. Supporting overseas investment in UK growth companies</td>
<td>Accelerate initiatives that encourage and attract overseas capital into existing and new UK equity growth funds, including role of EPC as cornerstone</td>
<td>GotoGrow bespoke scaleup trade missions a la London/Manchester models to be deployed across all regions and take learning from 5VC2UK to develop a reverse model and build on successful international investment models of SEB, Deloit and INI</td>
<td>Re-examine sectoral differences between key hubs around the UK, and encourage funding or support that specifically targets certain specialities or industries to help them grow and encourage a clustering effect</td>
<td>Enterprise Landing Zones to further assist overseas investment into the UK</td>
</tr>
</tbody>
</table>
CONTRIBUTORS

We thank all the parties with which we have had the opportunity to engage and discuss this report with:

- Agathos
- B-Lab UK
- Bank of England
- Barclays
- Beauhurst
- Beringea
- BGF
- Bio Industry Association (BIA)
- Blackrock
- British Chambers of Commerce
- Business in the Community (BITC)
- BVCA
- Can Do Scotland
- Centre for Entrepreneurs
- Confederation of British Industry (CBI)
- Deloitte
- E2Exchange
- EIS Association
- Entrepreneurial Giving
- Enterprise Trust
- Entrepreneurial Scotland
- Entrepreneurs’ Organization (EO)
- Enterprise Nation
- Federation of Small Businesses (FSB)
- Foresight Group
- Herbert-Smith-Freehills
- ICAEW
- Impact Investing Institute
- Independent Professionals and the Self-Employed (IPSE)
- Institute Finance
- Institute of Directors (IoD)
- KPMG
- London Stock Exchange Group
- Make UK
- ScaleUp Institute
- The ScaleUp Institute Finance Committee
- Silicon Valley Bank
- Tech Nation
- TheCityUK
- The Entrepreneurs Network
- The Industrial Strategy Council
- United Nations Global Compact
- University of Oxford, Said Business School
- UKBAA
- UK Finance
- VCTA
- YPO UK Leadership Council