UK investment fund for high-growth firms is a step in the right direction

Support packages for innovative firms are emerging as second-wave policy tools during the Covid-19 crisis. Following similar efforts in France and Germany, the UK government unveiled a £1B support package for start-ups, scale-ups, and research and development firms on 20 April, after having launched its main business support programs in March.

The new UK support package includes a novel £250M investment fund, called the Future Fund, targeting unlisted high-growth firms, specifically those that have raised at least £250K from third-party investors in the past five years. Through the Future Fund the government will buy convertible notes issued by the firms to make investments that are 50-50 matched by the private sector. Under the minimum terms set out by the government, unpaid notes will automatically convert into equity at a 20% discount on the most recent round price at the point of conversion.

What will the impact of the Future Fund be? Aside from anecdotal evidence from a few well-known examples, such as the Yozma programme in Israel, evidence for the success of private equity government interventions is still sparse. This is in large part due to difficulties in constructing meaningful counterfactual scenarios: What would have been the performance of firms absent the interventions?

The evidence from my recent research with Daniel Paravisini provides novel insights for the Future Fund. In this paper, we measure the effects of the Seed Enterprise Investment Scheme (SEIS), the UK flagship programme to incentivise equity investments by individual investors in high-growth firms. To construct meaningful counterfactuals, we exploit exogenous variation in participation from the program's firm-size unexpected eligibility threshold during its launch in 2012.

SEIS is a matching scheme that offers investors in unlisted firms a £1 tax rebate for every £2 invested, among other tax benefits. Its distinguishing feature is that eligibility is restricted to individual, third-party, non-controlling investors that buy ordinary shares. Perhaps as a result of this restriction, SEIS take-up relative to the eligible population is small: only a minor proportion of small businesses ever raise equity finance from third-party investors (2%). However, SEIS and similar tax incentives are quite popular among UK high-growth companies: since 2012, these incentives subsidised more than 30% of equity investment into these firms.

Our research results show that SEIS causes dramatic growth in some financially constrained start-ups that otherwise would not have occurred. The subsidised equity enabled these firms to raise seven times as much funding in debt, partly from the same equity investors. Why do investors complement their subsidised equity investments with debt such as convertible notes? Because debt allows them to force liquidation, seize assets, and replace management upon default. Without these contingent control rights, the risk for minority investors is that their remaining capital at risk (the part that was not matched by the government) will be held up in "zombie" start-ups that do not grow but also refuse to die.

These results constitute the first evidence that control rights matter for business angels. They also show that in settings where governments subsidise non-controlling common equity investments, like in the UK, business angel investors can implement control rights by buying debt securities alongside common shares.

Our research results offer two main lessons for the Future Fund. First, we show that subsidising third-party investment leads to high start-up growth that otherwise would not occur. Restricting Future Fund eligibility to firms that have already secured third-party investment will help the government hone in the right set of businesses for the scheme: those with high-growth potential, and that are otherwise hard to identify in the population of businesses. However, the Future Fund is not currently compatible with private equity tax incentives like SEIS. Our results imply that this incompatibility can lead to Future Fund underutilisation because participants may not be able to find investors that are willing to forgo the private equity tax incentives to provide the private sector match funding for the Future Fund.

Second, our results point to the prevalence of debt contracts in the UK early-stage firms funded through SEIS. Existing debt investors in these firms can be hard pressed to consent to the subordination of their securities to the government notes, because these notes specify a 100% premium repayment — meaning that firms will have to pay twice what they borrowed, plus 8% interest, to avoid conversion. The implication is that the implementation of Future Fund investments can be complex for these companies (and those funded with similar tax incentives), which can lead to further underutilisation.

While this premium charged by the government will make it more likely for it to capture some of the upside (and thus potentially avoid loss of taxpayers' money), it can undermine take-up. After the crisis, most potential beneficiaries will not expect to have enough cash to meet the premium. However, many would prefer to avoid conversion, because the Future Fund allows the government to sell the shares to institutional investors with few restrictions. The risk for start-ups is that the government offloads their shares to funds with interests in competitors, leading to conflicts of interest and potential negative value effects.

In conclusion, the Future Fund is a step in the right direction to help private equity cope amid the Covid-19 pandemic. However, its current design may undermine demand. To increase take-up, the government could make it compatible with SEIS (and other tax incentives), lower the premium, and cede transfer rights to start-ups. However, the optimal design should trade off the benefits from increased take-up against the potential long-term costs to taxpayers from streamlining the fund.

Notes:

- *This blog post is based on How Sensitive is Young Firm Investment to the Cost of Outside Equity? Evidence from a UK Tax Relief.*
- *The post expresses the views of its author(s), not the position of the CBI, LSE Business Review or the London School of Economics.*
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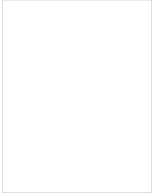

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