Why the UK needs a fund to support angel-backed startups

The Future Fund is the UK's flagship programme aiming to support startups that are affected by Covid-19. The demand for the Fund has been staggering; on its first day of operation, the applications amounted to almost twice the capital committed (£250M) by the government. While the significant uptake may be construed as an indication of the fund's success, questions remain. Some argue that startups should not be bailed out at all, and others raise issues about who benefits from taxpayer support. Is it possible that the Future Fund's current design is primarily a bailout for venture capital (VC) firms rather than startups?

The current Future Fund targets VC-backed companies

The Future Fund gives further runway to VC-backed companies, but excludes most other ambitious startups and scale-ups (75%), by virtue of its eligibility rules. To be eligible for the scheme, firms must have raised at least £250,000 in equity from third-party investors in previous funding rounds in the last five years. Companies that have not yet raised, or have only raised smaller angel rounds, are thus not covered.

In addition, the Future Fund is largely incompatible with tax reliefs for individual investors like the Seed Enterprise Investment Scheme (SEIS) or the Enterprise Investment Scheme (EIS), which fuel the UK startup ecosystem. Companies that raised SEIS/EIS rounds from angels using advanced security agreements (ASA) that had not been converted into shares prior to Covid-19 are not eligible for the scheme. Any angel investment made alongside the Future Fund as part of the matched funding will likewise not qualify for this relief, and risks access to SEIS/EIS for future rounds.

Why target VC-backed companies?

Ostensibly, the reason the Future Fund primarily serves VC-backed companies is that VC-backing is an indicator of quality. Startups that have secured VC money are, perhaps, Britain's current class of would-be unicorns. Another moot reason could be that the UK government is already a major investor in British VC; acting as a limited partner (LP) in more than a third of VC funds.

But this particular scheme may not be most needed by VC-backed startups. Startups with VC funding should be able to seek further funding from their investors, via round extensions, venture debt, or convertible notes. If their VC-backer has 'dry powder' (marketable securities that are highly liquid and considered cash-like) for follow-on funding, that money could be used to save, an even boost, portfolio companies.

What about angel-backed companies?

Angels are important providers of 'smart money' for British startups. Do angels not also deserve a lifeline? Prominent investors like Sherry Coutu argue that they do. Angel backing is also a crucial milestone for high-growth startups. VC backing is not the only signal of quality nor the only form of smart money in the market. For example, recent evidence from González-Uribe and Paravisini (2020) shows dramatic growth in startups after they raise angel financing using SEIS.

Moreover, relative to VC-backed firms, startups that raised angel rounds have less funding in the bank and limited access to venture debt, which means that they are at higher risk of collapse. This is also true for startups that have grown through grant funding or bootstrapping.

Is the current Future Fund a boost for VCs or for startups?

Given that VC-backed startups likely have more money in the bank and better access to further equity funding than earlier-stage companies, is it possible that the Future Fund's current design is primarily a bailout for VCs rather than startups?

Repayment terms are structured such that, in three years' time, taxpayers and VCs get 2X on their capital invested, or can take an equity stake. The 2X for investors sounds alarmingly similar to 2X liquidation preferences, which see VCs get paid 2X their capital invested before anyone else gets paid from an exit. Such preferences implies large costs for founders, and are not typical in today's market, even since the onset of the pandemic. VCs have only routinely applied such terms in crises like the dotcom crash. Is the provision of expensive capital what the Future Fund is really intending to accomplish?

A new Future Fund should target angel-backed startups

If the idea is to save future winners, why not set up a new Future Fund with a lower eligibility fundraising threshold so that angel-backed startups are eligible? The initial median investment for angel investors in the UK, according to the British Business Bank's 2018 report on the angel market, is £25,000. The current £250k target, thus, misses a large number of startups that had secured angel investment.

The Future Fund could reduce the minimum eligibility equity investment down to £100K (the maximum SEIS investment), which would also necessitate lowering the government's £125K minimum investment amount. Though the Future Fund cannot easily have full SEIS/EIS compatibility extended due to state aid rules, by lowering the minimum investment, the Fund would effectively target a SEIS-like cohort of startups.

In doing so, taxpayer money would be used to save the future of a greater number of high-potential, early-stage companies. This is particularly salient as the current Fund is already significantly oversubscribed, so the question of how to make fiscal funds last longer, and be impactful, is an important one. A reduction in the eligibility fundraising threshold would also help assuage the risk taken by angel investors, who have invested their own capital.

The effective cost of offering the new Future Fund is likely not much higher. While earlier stage firms carry a higher failure risk than VC-backed companies, the value of capital at risk is also much lower for earlier stage companies. Likewise, the likelihood of the government ending up with a significant portfolio of equity stakes, and the costs associated with efficiently off-loading such shares in the future, is already high for the current Future Fund.

To conclude, for the Future Fund to help save Britain's promising, early-stage startups from the challenges posed by the Covid-19 lockdown, it needs some changes to minimum fundraising size. Angel-backed startups should be eligible. Without these changes, the Future Fund will primarily boost the performance of VCs who see a 2X return and an artificial propping up of their portfolio.

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Notes:

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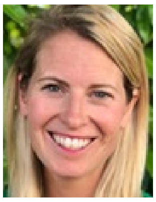

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Date originally posted: 2020-06-10

Permalink: https://blogs.lse.ac.uk/businessreview/2020/06/10/why-the-uk-needs-a-fund-to-support-angel-backed-startups/

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