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Policy Note #1: Equity finance for business growth: Shaping policy and informing practice

This Policy Briefing is one of a series informing policy-makers and interested parties of research at Leeds University Business School, which has achieved economic impact and has implications for the future.

The Times and Sunday Times Good University Guide 2020 has placed the Business School's Accounting and Finance Division 1st in the UK. The Briefing demonstrates the strong profile and reputation the division has within the field of equity finance, and the high regard in which it is held by clients in UK Government and the equity industry.

The findings from in-depth research on the role of equity funding for businesses, the scale of supply, the equity gap and regional disparities are from research undertaken by Professor Nick Wilson, Credit Risk and Finance, Head of Leeds University Business School's Division of Accounting and Finance, and Director of the Credit Management Research Centre. Several of the projects covered here were carried out in association with Professor Mike Wright, Imperial College Business School.[i]

Background

Equity finance – raising capital through the sale of shares in a business – is a topic of pressing and on-going importance. The level of capital investment in UK businesses has been low by international standards, not only in recent years, but over several decades. There has been much discussion of the 'equity gap', with insufficient capital – private equity and venture capital – made available to match entrepreneurial demand, leading to what's termed 'the valley of death', in which potential high growth and technically innovative businesses are under-capitalised or unfunded, restricting their growth and that of the UK economy. The issue of under-funding is seen as exacerbated by regional differences, with disparities in the availability of equity finance making access to capital more difficult for firms outside the South East of England.[ii]

This apparent market failure is believed to have contributed to the UK's relatively low productivity – both historic and on-going. This is a subject of recurring and increasing importance to HM Treasury (HMT) and the UK Department for Business, Energy and Industrial Strategy (BEIS); also, to the British Venture Capital Association (BVCA) and others representing investor interests.

Earlier public policy interventions have included the Enterprise Investment Scheme (EIS)[iii], Seed Enterprise Investment Scheme (SEIS)[iv] and Venture Capital Trusts (VCTs), all providing tax incentives for investors. More recently, the British Business Bank was set up in 2014 to increase the volume and diversity of finance options available to small and medium sized enterprises (SMEs). This support includes dedicated funds for the North of England and Midlands to address regional imbalances in venture capital activity: the Northern Powerhouse Investment Fund (£400m) and the Midlands Engine Investment Fund (£250m).

This policy briefing summarises research findings from Professor Wilson and colleagues on:

- **the importance of equity finance as a business growth mechanism** and contributor to economic growth, and
- **the case for bridging the gap in supply** at UK level and across the nations and regions:

how firms might access more easily the equity finance which would enable their growth.

Research evidence and policy implications

1. The role of equity funding: Post-investment performance of equity-funded firms, across the UK and in English regions

If ambitious, knowledge intensive firms can overcome the challenges of funding and scaling-up, they have the potential to make a significant contribution to UK economic growth. Typically, businesses look for early, relatively high risk, venture capital funding, then finance subsequent growth and restructuring through private equity investment. Research by Professor Wilson and colleagues found that private equity-backed buyouts achieved superior economic and financial performance in the periods before and after the 2008 recession, relative to comparable firms that were not equity-backed.[v]

Professor Wilson's research for BVCA subsequently assessed the performance of firms after receiving equity investment backing compared to that of non-invested companies. Robust evidence on the post-investment performance of equity financed firms had been limited. BVCA's intention in commissioning the work was to help investors focus on targets in the UK regions, as well as inform policy discussions between the industry, Government and the EU.

Findings and policy implications

The research assessed the potential demand for equity finance across UK regions, and the firm-level impact of equity finance investments on company growth, productivity and export performance. BVCA reported that the Wilson/Wright studies showed that, contrary to widespread perceptions, **private equity-backed businesses had not proved inherently riskier than other forms of investment**. This evidence was used to inform and influence policy-makers and media, with summary reports on the technical analysis of UK firm level data[vi] published on the BVCA website.[vii]

Professor Wilson's studies of private equity distress and resilience, exporting and regional funding improved the Association's understanding, actions and processes. **The research enabled BVCA to raise awareness and understanding nationally and internationally by making the policy case for private equity.** In particular, the research helped BVCA influence EU regulation of private equity:

> *"…Professor Wilson's studies on failure and resilience in private equity-backed business helped inform EU-wide moves to tighten the financial regulatory framework. Specifically, this led to a more nuanced understanding of the economic role of private equity in the Directive [Alternative Investment Fund Managers (AIFM) Directive]"* [viii]

The work around the growth of private equity-backed businesses in the North of England also provided evidence supporting the Government's initiatives to **strengthen regional growth through the 'Northern Powerhouse' vision**.

2. The role of equity funding: Private equity and business resilience

Private equity investors have been criticised for overleveraging portfolio firms (i.e. encouraging them to carry too much debt) and precipitating financial distress and failure. Professor Wilson has undertaken several studies on this topic.

Findings and policy implications

A study focused on the insolvency risk of buyouts over time compared matched private equity-backed buyouts and non-buyout companies over approximately 13 million company-years. It found that **private equity-backed buyouts were less likely to become insolvent than comparable non-private equity-backed buyouts** and listed companies, and that the former had performed better through the 2008 economic recession.[ix]

Another study of the effects of private equity investment found that **recipient companies outperformed a control group in terms of productivity growth** (9% faster). Further work has analysed the impact of private equity investment on exporting, and regional variations in equity finance investment and performance impacts.[x]

This research has been valued by the practitioner community, as evidence informing their members, influencing policy-makers and media, and promoting the private equity industry.

3. Bridging the UK equity funding gap: Incentives at national level

Before the 2016 Budget, HMT commissioned work to re-assess the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs), which had then been in place for over two decades. New proposals were considered, including extending the duration of the schemes from 2017 to 2025 with additional funding, new criteria for investee eligibility, and higher maximum investments. The European Commission had recently introduced new rules for risk finance measures, initially taking the view that EIS and VCTs might be in breach of EU State Aid rules. Approval from the Commission was required for the proposed extension and refinements.

If the schemes had been disallowed and halted, the UK would have lost major investment facilitation tools (estimated to bring £2bn venture capital investment annually) and faced fines and penalties. The challenge was to demonstrate that although, as with all targeted tax incentives, there was some interference with the market, any potentially negative effect was outweighed by the considerable benefits – business growth, new knowledge, skills and innovative practices – which would result in the wider economy.

Findings and policy implications

Professor Wilson was brought into an internal HMT team investigating the EIS, SEIS and VCTs. Drawing on his extensive database and analytic skills, he **estimated the scale of the equity gap and market failure** faced by UK early stage companies seeking finance. Econometric modelling of firm level data was used to estimate the demand for equity finance, its supply, and the size of the UK equity gap, particularly in knowledge intensive, potentially growing sectors.

The resulting report[xi] on market failure enabled the Treasury to obtain EU Commission State Aid clearance to continue EIS and VCTs in their revised form. In response to the submission, the European Commission concluded that the notified scheme was compatible with State Aid and relevant EU Articles[xii] – **the UK was the first member state to secure such approval**. The Finance Act 2018 included provisions that increased the annual amount a qualifying knowledge intensive company could raise under EIS and VCT from £5m to £10m.

4. Bridging the UK equity funding gap: Focus on regions

The Industrial Strategy 2017 recognised that the UK economy and equity mechanisms had been significantly oriented towards London and the South East of England, and that addressing this could bring economic benefits at both national and regional levels. BEIS commissioned research to better understand the drivers of regional equity finance, and ensure that any policy interventions would be based on rigorous economic evidence.

Professor Wilson's study assessed the demand and supply of venture capital through tracking the value and number of equity finance deals into knowledge-intensive and high-growth SMEs, in the UK's regions and devolved nations between 2011 and 2017, including analysis of the geographical distance between investors and investees.

Findings and policy implications

The report *Understanding Regional variations in Equity Finance*[xiii], published by BEIS, showed that **funding had continued to be concentrated in London and the South East**, with detrimental effects on efforts to rebalance the economy, and that this dominance was growing. It was also found that **investors tended to invest in proximate companies**. The report identified which regions were especially likely to face funding gaps, and where local investors were investing outside the region. **This research was used to justify the case for a £10 billion increase in venture capital investment in the UK regions**, to be achieved through the UK Shared Prosperity Fund delivered by the British Business Bank. BEIS stated:

> *"We now have a report that includes the first ever estimates of the SME equity finance gap produced on a quantitative basis for the whole of the UK and with a breakdown by region. And the*

report includes evidence of an array of demand and supply side factors that are responsible for the regional gaps and differences in equity provision" [xiv]

The evidence has helped change BEIS and HMT policy towards encouraging regional investment by venture capital firms. The UK Government has subsequently continued to promote investment outside the South East of England.

Note on Professor Wilson's expertise and interests

Professor Wilson, an academic since the 1980s, has also managed his own business. Since 1995, he has built up a specialised database of SMEs in the UK, based on credit ratings, scoring systems and algorithms. This includes complex data on sub-populations of firms that have received private equity or venture capital investment, within a wider dataset of UK companies. As such, it forms a unique up-to-date resource for understanding equity finance, and has been used to shape policy and inform practice in this field.

New datasets have also been created, drawing on Centre for Management Buy-Out Research data (held by Professor Wright), Companies House financial and director data, credit rating agency data, and other geographical and socio-economic data. This work has been supported by Marek Kacer (Research Fellow, Leeds University Business School) since 2014.

Professor Wilson has focused his research on providing new evidence which can inform debate and add authority and value to public policy. Through analysing equity finance related matters for Government departments and sector organisations, he has helped to generate economic impact through the redistribution of access to equity across the UK.

His experience and standing recently led to his research team's involvement in workshops organised by the Cabinet Office and UK Export Finance (UKEF) to analyse the provision and risks of export finance, and the use of Artificial Intelligence to model portfolio risks. His analysis of sectors and regions attractive to investment and the companies within these also has potential policy implications, e.g. for Digital Media and FinTech in the North of England. Nick Wilson's other interests include the role of Government as a co-investor, as developed by the Scottish Government[xv], and predicting and modelling credit risk and failure, and fraud. Potential beneficiaries of this research include SMEs, intermediaries (such as BVCA) and other policy-makers across Government.

Endnotes

[i] Sadly, Mike Wright recently passed away. Nick Wilson acknowledges the value Mike contributed to these projects, as a close colleague and friend.

[ii] See for example: Beauhurst (2020) The Deal: Equity investment in the UK 2019; British Business Bank (2020) Small Business Finance Markets 2019/20

[iii] Under the EIS small, private companies can raise finance. As this kind of investment is seen as high risk the Government offer an array of tax reliefs to investors. Companies (within 7 years of their first sales) can raise £5m per year up to a maximum of £12m in the company's lifetime.

[iv] Since EIS was launched in 1993-94, 29,770 companies have received investment and over £20 billion of funds have been raised. SEIS was launched in 2012-13 and 12,900 companies have received investment and over £1 billion of funds have been raised. See also: HM Revenue & Customs

[v] Wilson, N. et al. (2012) Private equity portfolio company performance during the global recession. *Journal of Corporate Finance,* 18(1):193-205. https://doi.org/10.1016/j.jcorpfin.2011.11.008

[vi] Private Equity, Buyouts and Distress; Private Equity-backed buyouts during the recession; Private Equity Buyouts and Exporting; Private Equity and the Northern Powerhouse

[vii] https://www.bvca.co.uk/Research/BVCA-Research-Reports

[viii] Quote from a former Director General of BVCA

[ix] Wilson, N. and Wright, M. (2013) Private Equity, Buyouts and Insolvency Risk. *Journal of Business Finance and Accounting*, 40:949-990. https://doi.org/10.1111/jbfa.12042

[x] Wilson, N. and Wright, M. (2016) Engines of growth: private equity and productivity potential in the North. *Report by Credit Management Research Centre and The Centre for Management Buy-out, sponsored by BVCA, Deloitte and North Edge*

[xi] Wilson, N., and Wright, M. (2015) The Equity Gap in the UK and Knowledge Intensive Firms, *Report prepared for HMT and HMRC*, June

[xii] European Commission State Aid SA.40991 (2015/N) decision document addressed to UK Foreign Secretary, 2015

[xiii] Wilson, N, Wright, M. and Kacer, M. (2019) Equity Finance and the UK Regions: Understanding Regional Variations in the Supply and Demand of Equity and Growth Finance for Business. BEIS Research Paper Number 2019/012

[xiv] BEIS letter 18th July 2019

[xv] https://www.scottish-enterprise.com/our-organisation/about-us/who-we-work-with/scottish-investment-bank

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