AIRTO Position Statement

Access to Finance for Innovation

SUMMARY

AIRTO's members provide important services that underpin the introduction of new and innovative products and services. Effective access to adequate finance is crucial to the success of businesses and organisations undertaking such developments, which need to be able to access the full range of competences, skills and expertise needed to bring their innovations to market.

AIRTO's members want to see an effective access to finance (A2F) ecosystem in place to provide a sound financial footing for innovative projects and ventures (particularly for smaller enterprises). Where the private sector ecosystem does not serve this need, innovators have to fall back on the public sector and grant support. However, most grants do not cover 100% of the full cost and so, even with a good system of grants, the requirement for access to private finance remains. The private sector access to finance ecosystem must be made to work.

Historically, there has been much criticism of the financial community regarding short-termism, a lack of understanding of technology and lack of focus on the needs of early stage and research and development intensive businesses. It is true that the A2F ecosystem in the UK is gradually improving in this regard, with assistance and encouragement from Government, but certain barriers remain which hinder access to and use of finance by UK businesses. In most respects the UK still lags the US in its ability to harness private sector funding for innovative ventures. This is particularly evident when it comes to smaller businesses.

Persisting barriers to effective use of finance include:

i. **Lack of sufficient understanding of:**
    - finance within many businesses (particularly SMEs)
    - early stage and technology based businesses, on the part of many or even the majority of financiers
    - both finance and business within many parts of Government and academia,

ii. **Aversion to, and insufficient capacity for, taking and managing risk.** This applies to many areas of the UK economy

iii. **Scarcity of capable, credible, experienced senior management** willing and able to take on new enterprises. This is perhaps the major factor holding back investment in innovation

iv. **Inflexible financing options and unhelpful pressures on growing businesses,** resulting from unhelpful operational structures and remuneration mechanisms common in some parts of the financial sector.

AIRTO will seek to expand its role in helping companies raise the finance needed for their innovation programmes.

Suggested actions for Government include:

i. Providing more encouragement and introducing additional measures to help communities come together to appreciate and understand how providing or receiving finance works. This could be extended to providing more encouragement for, and facilitation of, greater mobility of employment across these communities. Industry could also do more training to improve understanding and experience of key staff in finance

ii. Providing more encouragement and incentives for training in recognising, addressing and managing risk, particularly for smaller companies

iii. Enabling and incentivising more successful senior, experienced business people and entrepreneurs to reinvest both their wealth and management skills in new ventures
iv. Looking at how and where financial systems impede as well as support development of business.

Access to finance for AIRTO members is also important for their own operations as well as for supporting innovative companies. This poses special challenges for those that are not shareholder owned. The Catapult Centre model provides a rounded and balanced mechanism for financing new entities that are constitutionally independent from commercial ownership. An equivalent core/capital financing mechanism is needed for the existing private sector, non-shareholder owned organisations in the UK innovation sector, to enable them to continue to establish and maintain the advanced technical facilities and specialist expertise needed to support applied research and innovative for enterprises in the UK economy.

Background

It is widely recognised that a strong drive for innovation in products, services and businesses is the key to the UK's competitiveness in global markets and its exports. Without innovative, leading edge products and services, the UK's economy will fail to deliver the prosperity needed to support the standard of living to which we have become accustomed. Creating a favourable environment for innovation is therefore a fundamental component of the current drive to grow the UK's high-value, knowledge-based economy.

An important component of the drive to create a favourable environment for innovation is access to the necessary finance; without appropriate finance, innovation and competitiveness will be held back and business will be lost to overseas competitors. This is particularly important for organisations in the translational research and technology (innovation) sector who work with client companies to incorporate novel technologies into new products, processes and services. It applies not only to the availability of grants for research and development, but also to the flow of risk capital to underpin the insertion of such innovative developments into the marketplace and the provision of debt finance for working capital to sustain growth.

AIRTO members assist client companies and other bodies with many aspects of innovation, growth and project implementation, transforming research outcomes into successful commercial innovations and enabling clients to adopt and integrate such innovations into their businesses. The impact on the economy is significant, AIRTO's members alone turning over more than £4 billion per annum and employing more than 40,000 staff, together comprising one of the largest concentrations of highly qualified scientific and technical staff in the country outside the universities. The impact of this sector is set to grow with the creation of the Catapult Centres, adding further resource in new areas to the UK's already substantial capability for support to industry.

However, to really build upon this success story, it is essential there is a matching availability of appropriate finance, particularly to those seeking to grow their businesses and operations through the development and introduction of innovative ideas.

SUPPORTING DISCUSSION

Financing innovation and growth

1. Innovating to grow businesses involves change to products, services, equipment, facilities and other resources, requiring financing from company reserves and/or external sources. The latter includes equity financiers and various sources of debt finance. Grants for the development of technology are available from Innovate UK, the European Commission and some other providers.

2. The cost of resourcing innovation varies widely from sector to sector and with the nature of the project. For example, according to the ABPI[1], developing a new therapeutic product in the pharmaceutical industry takes 10-12 years on average and requires £1.15 billion of investment. The cost of developing an all-new model in the automotive industry is typically even higher at over £2 billion[2]. For small companies, typical requirements for finance range from a few tens of £k to a few £m, coming either as one off requirements or in stages. However, in all sectors and across all sizes of company, developing new products, components and services and bringing them to market requires access to finance.

Awareness and understanding of the access to finance ecosystem

3. There is a serious lack of awareness of available financing options, particularly among younger and smaller SMEs. The full range financing options includes the many and various types and sources of equity investment, debt and grants:

    i. Equity investment can come from friends and family, business angels, Enterprise Capital, Regional Growth and other public sector funds, family offices and high net worth individuals, venture capitalists, corporates and, increasingly, a proliferation of crowd funding and other peer-to-peer and 'alternative investment' platforms
    ii. Debt is available from banks, via asset and invoice financing and, again, from the newer crowd sourcing and peer-to-peer platforms
    iii. Grants for technology development are available from a wide variety of schemes, including from Innovate UK and the European Union as discussed above.

    Each source is suited to a different set of circumstances and requirements. Sifting through the options is not straightforward and there is a widespread need amongst those seeking finance for a better understanding of the workings, attitudes, approaches, criteria and jargon employed by each type of financier. Many of the perceived problems with access are due to mismatch between the propositions offered by those seeking finance and the requirements, expectations and perceptions of the financiers being contacted. A high priority for intermediaries is to close that gap, working with both companies and potential investors to develop better appreciation of what the other has to offer and to improve the mechanisms for putting companies in touch with the most appropriate financiers for their stage of development, type of business and funding needs.

    At present, there is no single source of advice covering all the various types of finance and possible options; most advice on offer comes from people representing, or with expertise in, a particular type of finance. Many companies say that they would value a 'one-stop' source of advice able to provide a comprehensive and holistic overview at a high level of the various alternatives available to them.

Dealing with risk

4. It is almost inevitable that there will be a degree of risk in developing new lines of business, in changing products, services or processes and in handling the resulting growth on a scale that can deliver acceptable returns on finance employed. This is also a significant risk for the financier. How risk is shared pervades all aspects of the relationship between financier and company.

5. For SMEs and start-up businesses, the issue of risk is brought into sharp focus as lenders seek to secure loans against assets, frequently requiring personal guarantees from directors. This deters many entrepreneurs and early stage SMEs from approaching lenders. Equity financiers cannot secure their investments in this way and cannot normally recover loses and so must seek very high returns in order to offset failed investments. Financiers have to calculate how much they can afford to lose in transactions that go wrong, leading to risk aversion and a relentless search for lower risk

opportunities. Many will only accept companies that have already generated revenues and profit, thus proving the viability of the business model and the management team. This leaves pre-revenue start-ups and early stage companies with particularly difficult challenges in the search for finance. The perceived nature and level of risk is therefore one of the major factors determining the availability of finance.

Availability of funds and supply side impediments to investment

6. Availability of new funds for banks, venture capitalists (VCs) and other institutional providers to invest is generally a function of their previous success in obtaining returns. It is of course also a function of the uncommitted funds at their disposal, the likelihood of a good return, the balance of risk against other elements of their portfolios and the liquidity of the market for selling on their existing holdings. This makes many investors wary of taking on transactions which are seen as risky, particularly involving early stage SMEs in sectors where it may take a long time to realise a worthwhile return. Biotech is a prime example. Institutional financiers are also constrained by the objectives and criteria written into their memoranda, which may exclude them from higher risk investments and difficult sectors.

7. The main concerns holding back financiers are thus dominated by the level of risk perceived in the propositions submitted to them and frequently, and perhaps paradoxically, a lack of sufficient ambition on the part of investees, which means that the financier cannot see from the business plans how the business will generate sufficient growth and profitability to make a return on the money supplied. Dealing with this is a matter of working with companies to improve their fitness to obtain and successfully use finance. Much of this effort will necessarily focus on the capabilities of the management team and their understanding of financiers and the profitable use of finance. The quality of the management team is of paramount importance and really good credible teams are in short supply.

8. There are also a number of infrastructural factors acting against the achievement of viable returns for early stage investors. These include lack of liquidity for their holdings and closed-end (typically 10-year) fund structures which require investors to realise disposals at times dictated by internal fund considerations rather than successful milestone achievement by investee companies. Refinancing at the wrong time for existing investors who cannot 'follow their money' results in heavy dilution and poor returns, deterring investment decisions until companies are more mature. This contributes to the market failure in private finance that leads to the need for Government intervention. Government should therefore work to find ways of helping to remove such barriers which make it difficult for early stage investors to be successful. At the same time it is necessary for institutional investors to have the means to finance their own activities without having to raise revenue from early disposals.

9. Overall, there is no shortage of capacity to invest, particularly for good quality propositions with acceptable levels of risk to the financier. What is perhaps in short supply is capital allocated for long term, 'patient' investment and good quality management teams for new enterprises.

10. Many responses to the challenge of assisting start-ups and SMEs to raise finance suggest that there is a need for additional funds and financing capacity. However, further consideration and analysis of experience in the field leads to the conclusion that the principal requirement is to help enterprises become more investable. This involves conveying business experience and knowledge of financing to enterprises that need it, through coaching, mentoring, training and recruitment of experienced people to management teams.

11. Looking ahead, investors and lenders will not have sufficient confidence to finance early stage businesses until there is a track record of acceptable returns from investment in the early stages of

company development. This will require factors currently deterring investors and lenders, particularly those factors which limit their liquidity and flexibility to realise returns at the most appropriate stage of company development, to be removed.

12. Finally, a specialist approach is needed to assist with financing for companies and organisations that are not owned and financed by shareholders. These include charities, companies limited by guarantee and social enterprises such as community interest companies. Their options for attracting risk capital are more constrained, not being permitted to accept finance in return for ownership of profit-distributing equity stakes in the organisation. However, such non-profit-distributing bodies are becoming increasingly popular, particularly where public funding is at the core of their operation.

Government interventions to date

13. Most of the political attention to date has been on sourcing equity finance for start-ups and early stage companies, boosting bank lending for early stage and medium sized enterprises and on provision of business support services to growth companies.

14. Faced with pressures to improve the flow of finance, to SMEs in particular, the Government has intervened to supply additional funds to banks and peer-to-peer communities for lending and to early stage fund managers for equity investment. It has also established subsidised schemes to develop SMEs with growth potential into more investible propositions for financiers. These latter schemes aim both to help SMEs ensure that their growth ambitions and plans are sufficient to underpin acceptable returns on the money supplied by financiers and to put in place measures to mitigate avoidable risks to themselves and their investors. Also, in areas such as technology development, these schemes help companies to approach grant providers, such as Innovate UK and the European Commission.

15. The supply of equity finance has contributed to starting and growing an increasing number of enterprises, but bank lending to small businesses remains stubbornly low. The rise in peer-to-peer lending and equity investment is becoming significant and that too is now supported by Government with public funds. Many companies have reserves to invest but still lack sufficient confidence in the global economy to invest in innovation and growth within their businesses. Incentives, such as r&d tax credits, help to mitigate such pressures to hold back on innovation.

16. Public sector procurement could be a major help to innovative SMEs. It has the potential to provide early revenue for small companies bringing innovative products and services to market, with Government acting as early adopter and commercial customer. Obvious examples can be found in sectors such as health care, education and defence. Government contracts increase the appeal of SMEs to private financiers and help to leverage more finance into supporting small company innovation and growth. More needs to be done by Government to expand procurement from the UK's innovative SMEs.

17. For the Government, helping companies to approach financiers and raise equity investment and debt from private sources for innovation projects, as well as offering grant support for the riskier proposals, can both increase the capacity for innovation in the economy and moderate demand for Government subsidies for research and development.

18. Nevertheless, in the short term, scaled up Government financing for support to such SMEs, particularly for pre-investment proof of concept verification, such as that offered through the Innovate UK SMART grants, would be very influential in enabling such companies to increase their appeal to private sector financiers and their ability to work with business support organisations, including members of AIRTO. Supplying resources to enable assistance to be afforded to SMEs seeking

finance in this and similar ways should be a priority for funding made available by Government to tackle access to finance challenges.

19. Government intervention is, for the time being, a persistent requirement and is likely to remain so until risky early stage financing of innovative companies demonstrates consistently acceptable returns over time for investor portfolios.

AIRTO's role

20. As trusted partners with industry, AIRTO members can play a crucial role in guiding companies through the process of obtaining and using external finance to support the development of their businesses. AIRTO members work with companies and other bodies to help them with innovation and growth. Some examples may be found on the AIRTO website and on its members' own websites. Members have an enormous amount of accumulated business and financing experience as well as huge practical expertise in implementing innovation and growth projects. Their skills are particularly focused on the stages of product and service development and subsequent proving for which smaller and medium sized companies typically need to raise external finance. Access to finance for these companies is therefore very important as they typically make up a proportion of the client base which benefits from members' services.

21. There are numerous examples of AIRTO members helping clients or potential clients with obtaining grant support for their projects. Furthermore, assistance with sourcing equity or debt finance as well is becoming increasingly common as a more holistic approach to financial support for smaller companies becomes more usual; indeed, PERA is already co-managing the BIS Growth Accelerator, which includes an Access to Finance strand.

22. AIRTO's community of members is uniquely placed to make connections not only between industry and academia but also to private sector finance and to sources of government assistance. AIRTO will seek to expand its role in helping companies raise the finance needed for their innovation programmes.

Access to finance for AIRTO members

23. Access to finance is also important for the growth and operation of AIRTO's members as well as for supporting innovative companies. Many of AIRTO's members, along with others in the translational research and technology sector, are non-profit distributing organisations with restricted options for raising finance. Without the ability to accept risk finance from shareholders in return for future payment of dividends, which would inherently compromise the commercial independence underpinning the status of such organisations, other mechanisms for raising finance have to be sought. This may involve sale of or borrowing against assets (if available) or pursuit of unsecured finance from sponsorship or grants. These options are not entirely satisfactory, particularly where organisations without a large asset base need to borrow to support cash flow or in cases where the investment needed to develop new capabilities and capacity cannot in the short term be supported from operational profit margins.

24. The Catapult Centre model offers a potential solution, providing a rounded and balanced mechanism for financing. This model is currently being used to bring on new entities in new areas of demand where there is a requirement for such organisations to be constitutionally independent from commercial ownership.

25. An equivalent to this core/capital financing mechanism for the new Catapult Centres is needed for the existing independent, non-shareholder owned organisations in the rest of the UK's innovation sector. This would enable such organisations to create a sound and robust platform for provision of the advanced technical facilities and specialist expertise needed to support applied research and innovation for enterprises in the already established but growing sectors of the UK economy. Adjusting the financing of these existing organisations in this manner would be a very cost-effective way of extending and building up the Catapult network and increasing the leverage obtained for the UK economy from this existing and valuable asset base.

References:

1. http://www.abpi.org.uk/industry-info/new-medicines/Pages/default.aspx

2. http://www.am-online.com/news/2012/11/27/cost-of-new-car-development-may-mean-cars-are-kept-for-longer/32009/

1 October 2014

Notes to Editors:

AIRTO – The Association for Innovation, Research and Technology Organisations – is the foremost membership body for organisations operating in the UK's translational research and technology sector. AIRTO's members deliver vital innovation and knowledge transfer services which include applied and collaborative R&D, frequently in conjunction with universities, consultancy, technology validation and testing, incubation of commercialisation opportunities and early stage financing. AIRTO members have a combined turnover of over £4 billion from clients both at home and outside the UK, and employ over 40,000 scientists, technologists and engineers. Many of its members were established to facilitate collaboration between industry partners with matching public sector financial support, similar in many respects to the modern day Catapults. Many of these original Research Associations have developed over time into successful independent businesses.

AIRTO members today also include commercial companies, modern Research and Technology Organisations and selected research and technology exploitation offices from universities, operating at the interface between academia and industry. Most of AIRTO's members operate in the important space between pure research and the pull of the market for commoditisation of knowledge into new products and services.

AIRTO exists to assist its members to network and to engage collectively with government and policy makers in the UK's R&D landscape on matters of mutual interest, including research policy, innovation strategy, encouraging enterprise and developing the commercial take up of scientific and technological advances. AIRTO works to influence and improve the strategy and climate for innovation for our Members by forging links and progressing dialogue with key decision makers in government and industry across technology intensive sectors. Our interests cover the activities of the Research Councils, Innovate UK, the European Commission and a number of UK Government Departments, as well as topics such as the use of public procurement to support innovation, challenge led research, skills provision, support schemes such as SBRI and those that deal with contract and collaborative R&D.

For further information on AIRTO please contact:
Dr Jane Gate
Director of Operations, AIRTO
Tel: +44(0)20 8943 6354
e-mail: jane.gate@airto.co.uk