

Institutional investment in the UK's scale-ups can't come soon enough

Scale-up companies in the UK face a dearth of capital, and too often they flee overseas in search of funding. Tweaks in the rules for institutional investors will be game-changing for venture capital investment, but more needs to be done to ensure that the UK's scale-ups get the capital they need to be successful.

Temps de lecture : minute

14 June 2023

When it comes to funding, the UK's scale-ups are betwixt and between. The big cheques for later-stage companies are out of reach, and they are beyond the seed and startup funding rounds. Like Goldilocks in the fairytale, they are looking for something that is not too big, and not too small; they need something that is just right. However, that right amount - at Series B and beyond - is difficult to find. There is a dearth of capital and the UK risks losing its most promising and innovative companies to countries with deeper pockets.

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It doesn't have to be this way and one solution lies with institutional investment. Historically, for various reasons, institutional investors have not allocated funds to venture capital. That could be set to change, however, with the government's steps to change rules for defined

contribution pension schemes - a welcome move that cannot come soon enough.

Any action that encourages institutional investors to invest in venture capital - and thus make funding available for scale-ups - is a win all round. It is a win for the scale-ups, who can continue to grow and don't need to go overseas or opt for an early exit. Meanwhile, the UK gets to keep its fastest-growing companies onshore, which will contribute to the UK's economy. For institutional investors, particularly in an uncertain economic environment - with rising inflation - they are able to find yield through investing in illiquid assets, such as scale-up companies. And, unlike the public companies they usually invest in, they can take a long-term view, which may be more in line with the profile of their customers and their retirement goals. Finally, those saving for retirement will benefit from having a more diverse portfolio. In fact, it may be more lucrative. According to 2019 research by the British Business Bank and Oliver Wyman, for example, retirement savings could be increased by 7% to 12% for a 22-year-old, if their defined contribution pension scheme made 5% of investments in UK scale-ups.

One impediment that pension funds faced was regulation that caps their charges, and how they are calculated, which made it difficult for them to invest in illiquid assets. The UK government has since made moves to make the performance fees exempt from the mandatory cap. This is part of the government's work in broadening the investment opportunities of defined contribution pension schemes. Also, the government noted in its final consultation on the issue that it intends to introduce "disclose and explain" rules so that funds are transparent about their allocation to illiquid assets, like venture capital. Not only does this force companies to actively think through their investment rationale, it also provides an opportunity for the wider industry to learn how others are investing. This in turn will lead to a much-needed body of knowledge about investing in this asset class.

Making changes to regulation is only half the battle; there are still many other hurdles that need to be overcome. Even with the regulatory impediments removed, there is still a reticence and hesitation by institutional investors to invest in illiquid assets. They have primarily been investing in the public markets, which requires a different approach. Investing in venture capital requires a more entrepreneurial mindset, a different approach to governance and management, and different risks.

Also, the ticket size of investments has been an issue. A scale-up - looking for an amount of funding that is just right, say around \$25M - will find that is not at the level where institutional investors want to play. Until more established investment vehicles are put in place for such assets, which enables investment that is not too big and not too small, this will continue to be an impediment.

Meanwhile, there is a more general reluctance to get involved in this asset class - mainly because it is not well understood. One way to get around this is for the easing of regulations to be accompanied by education and communication, and making sure that the institutional investors have the right knowledge and skills to take advantage of the opportunities of venture capital. That is not to say that things aren't moving in the right direction. They are, but there is still a long way to go until the UK's scale-ups can find investment that is not too big, not too small, but something that is just right.

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