Executive Insights

Volume XX, Issue 2

Radical yet Practical: Why the Patient Capital Initiative Will Produce Results

The potential impact of the Patient Capital initiatives, announced by the Chancellor in the Autumn Budget, would be of considerable importance at any time, but is especially timely as we head towards a more independent post-Brexit environment.

With small and medium-size enterprises (SMEs) representing 99.9% of private-sector companies and 60% of private sector jobs, the UK's international competitiveness could be boosted significantly by continuing to build on its ability to create and grow world-class innovative businesses.

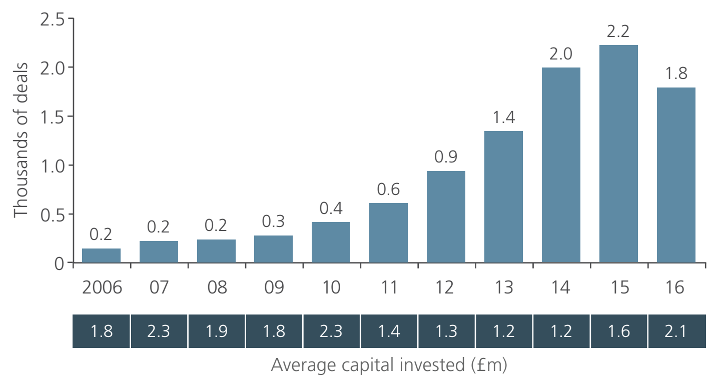
At L.E.K. Consulting, we are proud to have supported Sir Damon Buffini and the Industry Panel of Experts in developing their response and recommendations to the Patient Capital Review, and the contribution it made to the initiatives announced.

From strength to not quite so much strength: the UK's scale-up problem

The UK is already a successful environment for early stage businesses to set up and develop through the start-up phase. The number of venture deals and the amount invested has grown very strongly since c.2006 (see Figure 1), partly in consequence of the government's EIS and SEIS initiatives which have widely been credited with significant impact on the issue of attracting start-up investment.

Figure 1

Total UK venture deals (2006 -16)



Source: Pitchbook

However, when it comes to growth beyond the start-up phase, the UK's performance tails off, due to a relative scarcity of "next phase" investment of the type which has created world-class success stories in the US, for example (see Figure 2).

Vicious cycle to virtuous cycle: What the initiatives aim to achieve

So why does this gap exist? The Patient Capital Review concluded that a vicious cycle of poor risk-adjusted returns on scale-up investments, a lack of capital available to be invested in these businesses, and the subsequent lack of attractiveness to top investment and entrepreneurial talent, is responsible.

Radical yet Practical: Why the Patient Capital Initiative Will Produce Results was written by **Peter Ward**, a Partner in L.E.K Consulting's Financial Services practice and **Stuart Robertson**, a Manager. Peter and Stuart are based in London.

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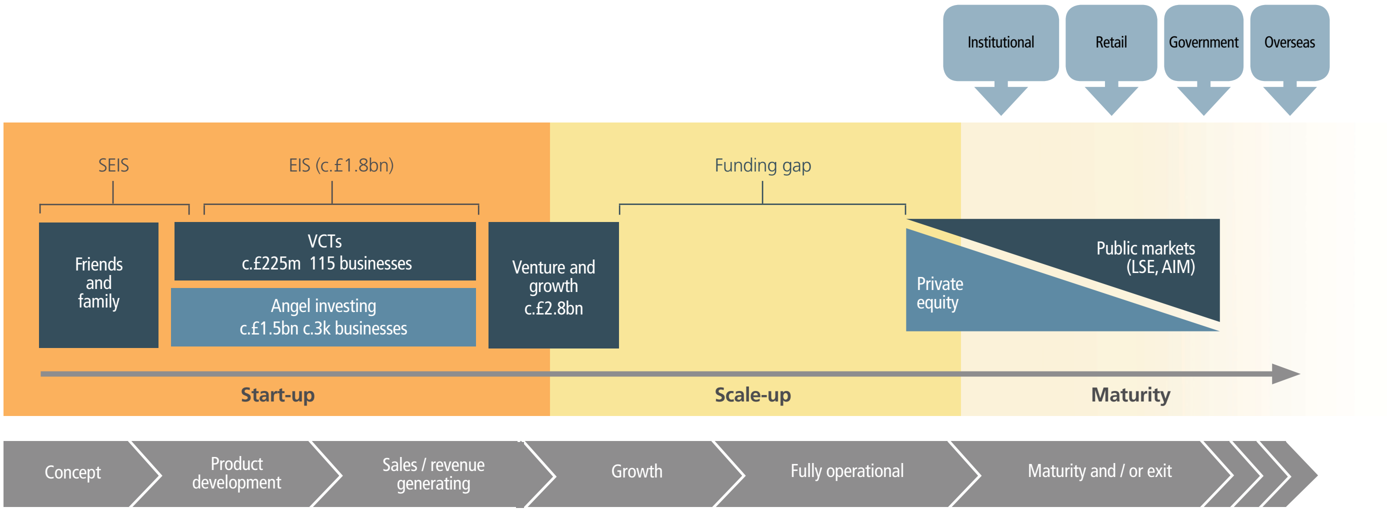
Figure 2

UK entrepreneurs are inhibited by a funding gap during the crucial scale-up phase



Source: L.E.K. analysis

What the Chancellor suggested in the Autumn budget is the development of a suite of initiatives to address these problems:

1. The establishment of new investment funds focused on 'patient' investment: these funds, specifically a £2.5 billion fund incubated by the British Business Bank, and a series of investments into private sector funds of funds seeded by British Business Bank capital, are intended to act as aggregators and providers of capital for investment in UK scale-up businesses and capital-intensive R&D-based businesses. Collectively, these initiatives aim to address the relative lack of capital to invest.

2. The continued support of emerging fund managers through Enterprise Capital Funds: this programme enables the British Business Bank to improve returns on equity for managers up to a certain size investing in start-ups, scale-ups and capital-intensive R&D-based businesses. This is achieved by "gearing" the return structure through co-investing British Business Bank capital alongside private capital, improving returns for investors.

3. The extension of EIS limits for knowledge-intensive companies (KICs): these measures directly improve the attractiveness of investments in those companies whose size is immediately above the currently permissible range, addressing the relative lack of capital to invest

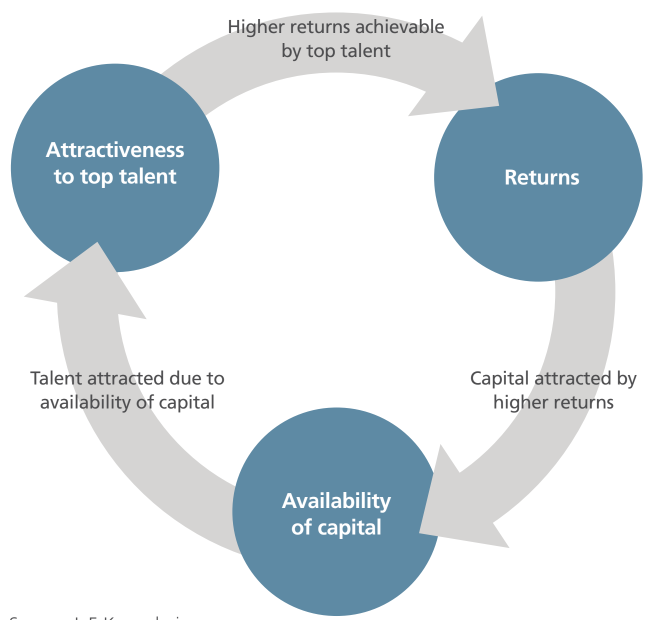
4. The Chancellor also announced a review of the barriers that may exist to pension funds choosing to invest 'patiently' in innovative firms. The potential removal or lowering of any such barriers could further add to the supply of capital available.

If successful, these initiatives would instead result in a virtuous circle of mutually self-reinforcing benefits (see Figure 3).

Taken together, this circle could transform the fortunes of innovative businesses aiming to reach scale, and make a significant contribution to the UK economy's competitiveness.

Figure 3

The virtuous circle achieved by successful implementation of the Patient Capital initiatives



Source: L.E.K. analysis

Radical yet practical: Why these initiatives could have substantial impact

Collectively, the measures suggested today are undoubtedly far-reaching and radical. Yet they are also practical in the sense that they (i) build on the current strengths of the UK's early stage investment environment; and / or (ii) are supported by directly relevant, demonstrably successful precedent in similar economies:

1. The new investment funds build on and support the current venture capital investment environment, rather than seeking to replace it;

2. The Enterprise Capital Funds programme is building on schemes already deployed;

3. The extension of the EIS programme builds directly on the very successful initiative which has had such a transformational impact on the UK's start-up environment; and

In our opinion, these initiatives have an excellent chance of success and we eagerly anticipate their implementation by the British Business Bank.

Further reading

Autumn Budget 2017
Financing growth in innovative firms

Patient Capital Review
Industry Panel Response

Financing growth in innovative firms: consultation responses

About the Authors:

Peter Ward is a Partner in L.E.K.'s London office. Having joined L.E.K. in 2000, his primary focus has been corporate strategy development, complemented by substantial experience in buy and sell side commercial due diligence, commercial bid support and litigation support. He also has significant expertise in performance measurement and incentive structures, both within organisations and across contractual boundaries. Peter has deep sector expertise in regulated industries, principally financial services, including advice on regulatory submissions

Stuart Robertson is an Engagement Manager in L.E.K.'s London office, and leads L.E.K.'s Disruptive Analytics initiative. He has extensive strategy experience across both the private and public sectors, and has provided strategy and transaction support to start-ups in a range of industries. Earlier in his career, Stuart completed a secondment with HM Treasury and the Cabinet Office as a financial expert for major projects. He holds an MA in Mathematics from Cambridge University.

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