



ENTERPRISE INVESTMENT SCHEME KNOWLEDGE-INTENSIVE FUND CONSULTATION

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ICAEW welcomes the opportunity to comment on the *Enterprise Investment Scheme knowledge-intensive fund consultation* published by HM Treasury on 13 March 2018, a copy of which is available from this [link](#).

This response of 11 May 2018 has been prepared by the ICAEW Corporate Finance Faculty and the Tax Faculty.

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MAJOR POINTS

1. Funding and follow-on funding challenges exist for businesses in capital and/or R&D-intensive sectors that are expected to have long periods until first commercial sale. Not all knowledge-intensive businesses have such difficulties - eg, there is no lack of funding for technology/digital - rather it is those in life sciences and advanced engineering.
2. The current EIS scheme - including the recent reforms - is considered to effective in channelling capital generally to knowledge-intensive companies but not to companies in the subsectors above. A new EIS fund structure might more usefully be targeted at specific subsectors rather than at the population of knowledge-intensive companies.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Why are some younger knowledge-intensive companies unable to obtain the levels of patient capital that they require?

3. It is not the case that all knowledge-intensive sectors are unable to attract patient capital. Some sources suggest¹ that the funding environment is positive for companies in the technology sector, especially digital and software companies. By contrast, there is a 'genuine capital gap' for companies in life sciences - in particular, biotech - and advanced engineering, principally due to the long timeframes (over 5-15 years) involved in producing results.
4. Other reasons include a company's age or rate of growth. Younger companies are also less prepared for attracting funding and often do not display what investors expect to see in place such as basic planning systems and a solid management team. High growth companies that quickly breach size thresholds in the tax-advantaged schemes, find follow-on funding hard to raise.

Q2: What would be the best way(s) of further improving the flow of patient capital to knowledge-intensive companies, bearing in mind state aid constraints?

5. The government's recent reforms within the EIS and VCT schemes for knowledge-intensive companies will help improve the flow of patient capital for certain companies, and should be combined with necessary measures to help them to become investment-ready. Guidance on the schemes can include making companies aware of the value and opportunities that professional advice at an early stage can bring. ICAEW's Business Advice Service (www.icaew.com/bas) is one of many services that are freely available and that could be signposted.
6. For others companies, however, such as ones in biotech or advanced engineering with lengthy pre-production and pre-revenue periods, there is an argument that the limits on investment size need to be even higher so as to improve their ability to access follow-on funding. For very early-stage companies, the operating cost condition could be difficult to meet in the three years following investment. There may also be challenges to prove the innovation condition too, if an appropriate independent expert in the area of innovation cannot be found. As set out in our response to Q6, the proposal for an EIF fund structure may be better targeted at such companies.

¹ See, for example, www.techcitynews.com/investment-tracker

Q3: What barriers are there to the development of investment funds that specifically target knowledge-intensive companies?

7. As the paper states, EIS funds are currently available. Some are sector specific, with technology being a common 'specialist' sector, while others invest in a variety of sectors.
8. Fund managers that raise and deploy capital to knowledge-intensive companies need to be able to draw upon specialist sector knowledge that may be scarce. ICAEW has previously suggested that public money could support centres of STEM investment expertise and fund management excellence.

Q4: Would a targeted knowledge-intensive EIS fund model help increase the supply of patient capital to knowledge-intensive companies?

9. In principle, yes, but it would be difficult to estimate the increase.

Q5: Which of the options outlined above would most attract investors to knowledge-intensive funds? Please rank and critically compare the benefits and disadvantages of each.

10. From an investor's perspective, we would rank the options as follows (from most to least attractive):
 - Tax free dividends (though unlikely to be material)
 - CGT relief
 - Upfront tax relief
 - Carry back and refund

Q6: What other features would a knowledge-intensive EIS fund need in order to address the funding gap for knowledge-intensive companies, keeping in mind the constraints within which such a structure would be created?

11. We have no comment on this.

Q7: Would a 'patient' dividend tax exemption provide the right incentive to both attract investors in the fund structure, and encourage longer-term approaches to investment?

12. We have anecdotal feedback that this would not have a material impact.

Q8: To what extent would relief at the level of the fund be attractive when weighed against the additional complexity that would be necessary?

13. We previously refer to the requirement for sector expertise and other implications will also determine whether a fund manager seeks to manage EIS funds. Obtaining upfront tax relief would clearly help mitigate the complexity involved in meeting the EIS criteria. Some suggest that this might be in the region of 3% of annual fund costs, which over the life of a fund could be substantial.