Written evidence submitted by Longwall Venture Partners LLP

Longwall Venture Partners LLP ("Longwall") manages three Enterprise Capital Funds totalling £145M focussed on making investments in health, security and sustainability. We invest in seed and early stage UK companies covering a range of sectors from healthcare and diagnostics, scientific instrumentation, space, clean energy and manufacturing . All of our companies have advanced IP, most involve development of hardware, and all represent the cutting edge application of science to create world-leading companies, building on the ambition to make the UK a science and technology 'superpower'.

We tap into world-leading science and research at the UK's top universities as well as government entities such as the Rutherford Appleton Lab at Harwell. Our companies are technology companies at heart; they develop and sell new technologies rather than using established technology to create new business models.

We welcome this opportunity to give our perspective on the venture capital market.

We are facing uncertain times. 2022 has seen a collapse in risk appetite in the general market and this will in time feed through to the venture capital market. We will see a reduction in risk capital available, unless action is taken to create incentives to attract further funding into this area.

The Current State of the UK venture capital industry

The UK venture capital industry has grown significantly in the past five years and there are now considerably more opportunities to invest in early stage companies thanks to the growth in EIS funding and the work of the British Business Bank in supporting new venture capital managers through schemes such as the Enterprise Capital Fund programme.

However this is not a universal truth and there are sectors within early stage UK venture where, despite a considerable depth of opportunities generated within the UK and the importance of some of the issues that these opportunities address, both to the UK and globally, the required funding remains scarce. For example, our sector of businesses building 'deep tech' hardware and life sciences. This sector is a small one in the context of the country's venture capital market, but a very important one for the long term future of the UK economy:

The issues are as follows:

i) Few VC firms are willing to take real technology risk - a fundamental part of early stage investing, especially where the product is hardware-based which is perceived as more difficult to get returns and requiring more capital;

ii) Such companies take a long time to develop, in some cases they will not be revenue generating for many years, meaning it can be hard to attract new investors or meaningful uplifts in valuation. More crucially it can also take longer to find out whether or not the product will work and therefore which companies to back and which to drop; and

iii) deep-tech investments require experienced managers with a combination of industrial and commercial experience and scientific understanding as well as venture capital experience. These are scarce. EIS investors provide some of the capital required, but often not time or experience to build these businesses, and often invest most at their initial investment rather than nor in practice act as a credible lead investor.

As a result of the above VCs and other investors are often drawn to sectors where timescales are shorter and results are achieved more quickly.

But such investments have the following benefits:

i) They complete the 'virtuous circle' by commercialising world leading science research and paying dividends to UK universities and research centres, enabling those centres to invest in future programmes and attract top overseas talent;

ii) They create high growth potential businesses with many highly skilled jobs for top talent both in the UK and overseas;

iii) They address many of the key challenges facing the world, be it rapid diagnosis of cancer, more efficient production of clean energy or enabling more efficient manufacturing processes;

iv) They attract inward investment into the UK;

v) Their problems have a global market with a strong focus on export business; and

vi) When these companies are sold, the business usually stays in the UK even if the new owners are overseas. Software jobs can easily move abroad, but machinery and supply networks usually stay where they are.

Given the above it is vital that funding remains available for this and similar sectors as without such funding these businesses will just not develop.

As noted above it is acknowledged that government actions in this area have been helpful in many cases, but there have also unforeseen consequences of other actions. In particular Local Government Pension Schemes (LGPS's) have a track record of support for these fund managers, and rightly so. Such institutional funds are ideally suited to the investment timelines and returns profile that is mentioned above, and have the financial firepower to make a difference. However recent changes and the introduction of 'pooling' of the local authority schemes into larger groups has had a detrimental impact on the availability of this capital for the following reasons:

i) Larger investment funds naturally mean an increase in minimum allocations. For some LGPSs, where we have previous seen commitments of £5-10M, the threshold is now £50-100M. Yet early stage venture funds are often relatively small (say £30-100M) and therefore now an investment in such a small fund is out of scope for the pooled entities

ii) Fees and costs remain an issue: active asset management is, by its nature more expensive than passive management and as discussed, can be a long journey. In a push to reduce costs for their investors, larger pension funds are pushing towards a general programme of cost reduction which ultimately has the effect of turning funds towards passive, equity tracker investments.

iii) Economies of scale, administration and regulation also naturally push these pooled managers towards fewer passive investments, where fewer inhouse staff are required, as these further reduce their costs as smaller funds like ours require the same due diligence, monitoring and reporting as a much larger investment manager.

Our funds are relatively small – in common with others in the very early stage sector. Larger funds are forced for economic reasons to invest in more established businesses, and we wish to invest where we can make the biggest difference and where we believe the UK's need is greatest. We believe it is important that it is still possible to attract investment to smaller vehicles from large pension funds.

It should be noted that although this has focussed on the changes to LGPSs, many of these issues are also present with all pension funds, and we welcome any steps taken to allow DC pension schemes to invest in this area.

Tax incentives

We have no shortage of attractive investments, but getting long term commitments to a small fund investing at the riskiest stage of investments is a challenge. EIS and SEIS schemes, though increasingly complex to manage, have attracted much new investment into start ups. However EIS is not available to investors in our fund. Individuals investing under EIS are incentivised to invest for short periods (3-5 years) and our drawdown profile of investing over several years is incompatible with EIS legislation.

In addition, investments in companies via funds such as ours are not eligible for any Inheritance Tax deductions, whereas they would be if they held the shares in the underlying businesses directly. Where often wealthy individuals are considering early stage investing as part of their financial planning, these factors serve to reduce the attractiveness of early stage funds.

We welcome creative solutions to these issues.

1. We would like a statement from the Treasury to LGPSs that encourages a continued commitment to an investment allocation in early stage UK venture to support the long term future of the UK economy
2. We would encourage the continuation of the reforms of Defined Contribution pension schemes, in such a way that encourages a longer term view and support of active venture capital managers rather than passive investing
3. Recognising that an investment in a small VC fund cannot be traded, the FCA and the pension fund industry should **modify the regulatory framework** such that monitoring is less onerous and relies on the monitoring already done by a lead investor such as BBB.

Other recommendations to improve availability of capital to early stage funds:

1. Investments by individuals in small companies are exempt from inheritance tax, yet investment in LP funds such as ours investing in the same companies are not. We would like to level the playing field by exempting small funds investing entirely in private companies from inheritance tax.
2. We would like to see the ISA regime extended to encourage investment in early stage venture limited partnerships. A separate allocation to this sector (in addition to the public equity market allowance) would be a powerful and effective move to increase funding to a critical sector.

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