BVCA response to the City Growth Commission call for evidence

About the BVCA

This response is submitted on behalf of the British Private Equity and Venture Capital Association ("BVCA").

The BVCA is the industry body and public body advocate for the private equity and venture capital industry in the UK. More than 500 firms make up the BVCA members, including over 250 private equity, mid market and venture capital firms, together with over 250 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

Foreword

Britain is a distinctly urban nation, with almost half of its population living in large cities. This significant factor makes these locations potential powerhouses for economic growth and job creation as the country continues to recover from the economic crisis. Despite this opportunity, the UK continues to disproportionately depend on London to generate a substantial proportion of this growth and employment. This leaves regional cities without sufficient job growth and business investment, with the state often acting as the largest employer.

As a significant investor in the regions, private equity and venture capital are well placed to contribute to this debate on the development of cities outside of London. Fund managers currently maintain investments in local business in cities including Manchester, Nottingham, Newcastle and Bristol. Findings from our recent publications *The Growth Initiative* and *Tech Country* have highlighted the potential for regional cities to develop existing nascent clusters into national, if not global, success stories. The BVCA believes that focussing policy on areas that already show promise is vital for kick-starting regional growth. Evidently, rebalancing the British economy away from London is no small task, and as such it is vital that such a project be based on existing strong foundations. Significantly however, the further development of these foundations is dependent on a number of drivers including a skilled labour force, sufficient finance, strong infrastructure and supportive business networks. If we are to develop strong regional cities we must analyse and enhance all of these aspects of the economy.

Whilst the Government has attempted to encourage the development of these features through policies such as Local Enterprise Partnerships (LEPs), City Deals, the Regional Growth Fund and Enterprise Capital Funds, there remain a number of untapped local opportunities to encourage regional city-based growth. In particular, Britain's world-class universities have the potential to spinout innovative start-ups that remain local, providing jobs and growth for their cities, whilst also contributing to the UK's position as a leader in high-tech development. Whilst Cambridge offers the best example of this activity, cities such as Manchester and Bristol show great promise yet lack the necessary networks with business and finance required to encourage entrepreneurial academics out of the lecture theatre and into the corporate world.

By extension, the existing state of affairs results in a two-fold 'brain drain' away from the regional cities. First, entrepreneurial academics are unlikely to spinout and create new high knowledge businesses in their university city, potentially moving to locations such as London or Cambridge to seek funding or employment in their field of work. Second, given the absence of firms requiring their skills, graduates are likely to be drawn to cities where they can find gainful employment, with London again receiving much of the talent pool. With the cultivation of links between universities and business this 'brain drain' will likely slow. If entrepreneurs stay in their university city to spinout and commercialise their research we would expect them to eventually provide skilled jobs for graduates. This process then aids our regional cities more generally as people are increasingly willing to settle away from London and the Southeast, buying homes and building families, thus contributing to their growth and development.

In recognising and taking advantage of the potential of all its cities, the UK stands to benefit from a more balanced economy with a better distribution of growth and jobs. Of core importance, however, is that this process engages central and local government, business leaders, local organisations and academic institutions. A piecemeal or top-down approach risks extending London's dominance at the cost of the regions for years to come.

Detailed responses to individual questions are below.

1. **What are the key benefits – for the economy, investment, innovation, productivity and public finances – of shifting to a multi-polar growth model, in which our major cities are key players in the nation's economy?**

The imbalance of wealth and jobs in the UK, skewed towards the Southeast more generally and London in particular, is well known. This inequality creates a persistent cyclical effect whereby investment and talent is drawn to the capital, starving regional cities of finance and related job growth. Despite often being depicted as a beneficiary alone, London is also harmed by this relationship as it experiences further congestion, land scarcity, rising property prices and marginalised human capital leading to diminishing returns. Enabling the development of our regional cities would dilute this overconcentration and create a more broadly balanced economy, which would likely prove more resilient in any future crisis.

Cities play a particularly important role in this rebalancing given Britain's position as a global leader in the high value knowledge, service, finance, science and high-tech industries. These firms are drawn to cities as they seek to be based close to their business partners as well as their competitors, whilst having access to skilled graduate labour and other services such as key transport links. Developing our regional cities to attract such companies is therefore a highly sensible proposition. As part of any project to achieve this, however, it is essential that we take advantage of existing assets, rather than attempting to generate new business hubs and networks from thin air. Indeed, success is far more likely if the Government attempts to marry its objectives with economic realities. Cities such as Manchester, Cambridge and Bristol represent examples of this success and are already experiencing the benefits of greater engagement between their universities, local business leaders and investors. Leading universities in cities such as Leeds, Sheffield and Newcastle could prove similarly important in developing innovative ideas that can be spun out leading to investment, jobs and growth.

2. **What does the international evidence show about the role of cities in driving growth and catalysing innovation? What are the key success factors that we can learn from?**

3. **What is the relationship between public service reform and economic growth at city level? How can more effective demand management – through public service reconfiguration and integration for instance – help to drive social and economic productivity? Can this enable our cities to become more financially sustainable?**

4. **How can decision-making and responsibility for public policy and public services be better aligned with the reality of local labour markets? How can policies around employment support, childcare, skills policy, welfare strategy and economic development better reflect the needs of local people and businesses?**

As the UK continues its lengthy recovery from the 2008 financial crisis, the public and businesses are primarily interested in jobs and economic growth. If the Government wishes to generate greater growth and more jobs whilst promoting a multi-polar economy, it will need to design schemes that make regional cities more attractive locations for investment. Two core components that must be addressed to achieve this appeal are the development of adequate skills provision and an efficient infrastructure network.

Whilst more young people are entering university than ever before, businesses across the country continue to voice concerns that those seeking work lack their required skill sets. British universities are of course continuing to cultivate well educated individuals, however too few of them specialise in science, technology, maths and engineering (STEM subjects). Sectors that involve these fields of study are becoming increasingly important to the UK economy and it is essential that our education system provides adequately skilled candidates to fill the job vacancies they create. As such we welcome the announcement made by the Chancellor in the 2013 Autumn Statement that the Treasury will provide an extra £50m to universities to enable a greater number of students to study STEM subjects. Nonetheless we believe that businesses themselves are best placed to assess the skill sets they require and support the shift of control of skills policy and budgets towards local employers as much as possible. This is potentially achievable through LEPs, which are more able to take account of local economic nuances. The Government has stated that skills should be a core priority for LEPs and that it is willing to transfer a nominal amount of the skills budget to the partnerships, although this would be placed in a single local growth fund and not be ring-fenced. If LEPs are to have real impact greater commitments are required to enable educational institutions in regional cities to be better geared towards contributing to the local and national economy.

Infrastructure would similarly benefit from greater input from local employers. Through consultation and a greater understanding of their specific requirements, whether relating to energy, transport, telecommunications or waste, local infrastructure strategy could play a vital role in encouraging further economic growth and job creation. London, through the Mayor of London and the London Assembly, has demonstrated the ability to improve services within a city when decision-making and finance is devolved. Since their inception however, some LEPs have struggled to take full advantage of schemes intended to develop local infrastructure. The main source of finance for such projects is currently the Government's £500m 'Growing Places' fund which provides loans alongside a smaller number of direct grants. Whilst the scheme has successfully assisted hundreds of infrastructure developments, the geographical spread of the money has proven problematic. This is due to the fund being split between LEPs based on the size of the partnership and their current economic activity. This resulted in 35 percent of the fund being allotted to London and the Southeast, whilst the Northeast received only 4.5 percent. If we are to ensure that regional cities have strong foundations for growth, this means of allotting infrastructure funding may be ill-conceived. Instead, a greater recognition for prospective growth within particular LEPs should be included, preparing those locations for future development.

5. **How can growth in other English cities complement London's economic success? What should be the interrelationship between devolution, growth and reform strategies in London and in our other major cities?**

As mentioned in our response to question 1, the imbalance between London and regional cities is also harmful to the capital itself with increasing congestion, expensive property and marginalised human capital resulting in diminishing returns. Encouraging growth in regional cities may provide something of a 'safety valve' function for London, ensuring its continued prosperity by reducing the overconcentration of both labour and business. Similarly, in a country as small as the UK, and given the clear leadership of London in the services and financial sectors, there should be little concern of other cities providing damaging competition to the capital. These factors demonstrate that promoting the growth of cities such as Leeds, Sheffield and Newcastle is by no means a zero-sum game, with the country as a whole standing to benefit from a renewed national development strategy.

As our report *Tech Country* highlights, various cities outside of London are already specialising in innovative sectors of high tech industry, which play an increasingly important role in the British economy. The Government is well aware of this shift, with the Department for Business, Innovation and Skills highlighting 'Eight Great Technologies', which include advanced materials, synthetic biology and robotics, as vital to Britain's future industrial strategy. Guaranteeing our leadership in these fields means reinforcing and cultivating the environments that encourage these firms to be created and subsequently flourish, a theme we will expand on in question 7. The ICT cluster in Cambridge which produced globally renowned microchip firm ARM Holdings, and the material science cluster in Manchester which is developing the revolutionary substance graphene offer but two examples of the high profile and potentially high growth technologies being developed across the UK.

6. **What needs to change between Whitehall and our cities to make multi-polar growth a reality? What does the Centre need to do to enable this and what economic and revenue levers do cities require?**

Much of the analysis investigating the cause of inequalities between London and other English cities centres on the impact of governance. More specifically the focus, or perhaps blame, is targeted at the UK's highly centralised political system. Notably, London is the only English city permitted any significant degree of autonomy from Whitehall, with its elected assembly and Mayor assuming substantial control over transport and planning arrangements. Regional cities on the other hand experience more substantial direct control from Whitehall. This is then split across Government departments leading to a disjointed approach to city policy, which has the potential to inhibit passionate local leadership and entrepreneurialism that would likely help the cities to prosper.

Whilst the creation of Local Enterprise Partnerships and the subsequent Enterprise Zone scheme as tools for enabling the improved coordination and development of local infrastructure projects and business growth is a promising development, changes are required. LEPs in particular require statutory status and more adequate funding if they are to prove to be as effective in encouraging local development as the Government hopes. More specifically, and as we highlighted in question 4, the need for the transfer of greater political and financial responsibility over skills and infrastructure matters to LEPs has been recognised, yet there appears to be little evidence of this taking place to any substantial degree. Rather than depending on programmes developed in Whitehall, we must enable the UK's cities to take advantage of the cumulative knowledge and experience of local businesses. Regional employers are acutely aware of the skills they require to expand their firms and as such engaging them in related strategy development will enable their companies to take a greater role in the success of their respective cities. Likewise, businesses established in London and the Southeast, aware of a growing pool of skilled young people in the Midlands and further North, are more likely to consider expanding to these areas, reinforcing the ultimate goal of balancing the economy through a multi-polar structure. This course of action again highlights the benefits of taking advantage of existing assets in our regional cities, rather than attempting to develop a regional growth strategy with no foundation.

A related issue that remains important, particularly if the Government proves reluctant to pursue downward transfers of decision-making and financial control, is the necessity of long-term planning. Under the existing centralised system major decisions relating to cities depend on the political weather in Westminster, rather than the economic realities experienced outside of London. The five-year Parliamentary cycle holds sway, interrupting and delaying transport infrastructure developments in particular, some of which require stability over several decades to be implemented successfully. When examined from an international perspective, connections between our cities are relatively slow and restricted by limited capacity. The commitment by consecutive governments in countries such as France and Germany to build extensive modern rail systems has benefited their regional cities immensely. It is therefore vital that British politicians recognise this link between long-term planning and regional growth as they seek to rebalance the economy away from the Southeast.

7. **What other practical, organisational, cultural and systemic barriers stand in the way of a fundamental shift in economic power to our cities and how can these be overcome?**

Improving Relations between Universities and Business:

Cities are natural hubs for knowledge, culture and business. When these are well cultivated they create thriving urban areas that generate wealth and jobs. Whilst London is probably the best example of this successful union in Britain, it currently acts as a 'brain drain' for the rest of the country pulling talent away from the regions that need it most. Increased funding to STEM subjects as well as devolved skills strategy can make England's regional cities more inviting to business and graduates as we continue to shift towards knowledge-intensive and high tech industries, but we must also make them attractive to pioneering university researchers. We believe that this requires the fostering of a collaborative environment that offers the UK's most promising entrepreneurial academics the career prospects that make London so attractive today.

As we have mentioned elsewhere in this submission, the UK is already home to a number of successful firms that have been spun out of universities, commercialising their research and creating world-leading technologies and products. University of Manchester Intellectual Property (UMIP) and Cambridge Enterprise Ltd are two of the best-known bodies that oversee this bridge between universities and business. Since 2004, UMIP has overseen £225m of venture capital investments for its 30 student-led and 16 staff-led spinouts. As a symbol of similar potential, Cambridge Enterprise has examined over 300 proposals for new companies since 2007.

A number of Government-led schemes also exist to encourage this partnership. We particularly welcome the Research Partnership Investment Fund, which has raised over £1.1bn from the private and charitable sectors after an initial Government investment of £300m. The fund has led to twenty collaborative projects including the National Automotive Innovation Campus, bringing together Jaguar Land Rover, Tata Motors and the University of Warwick, and the Material Innovations Factory, a collaboration between the University of Liverpool and Unilever.

The Technology Strategy Board's 'Catapult Centres', which bring together British businesses, scientists and engineers to transform ideas into new products and services, offer another potential source for growth in the UK's regional cities. Currently, however, the centres are thinly spread across geographies and require more concentrated investment if they are to help create critical mass within pioneering clusters. Similarly, whilst existing arrangements target late-stage research development, we believe that by enhancing their support for early research phases, Catapult Centres would be better positioned to ensure that promising blue skies research moves closer to commercialisation. We also suggest that the Technology Strategy Board should provide scientific research teams grants with no intellectual property attachment, in order to help bring the project to the next stage of development and in particular the venture capital investment stage.

Despite these encouraging developments their scope remains narrow. Whilst we often hear of pioneering research from the better-known universities, unleashing the potential of other regional city universities to commercialise their research will prove a lucrative boon to economic growth. As such the creation of further facilities designed to encourage the development of relationships between universities and business leaders is required. The reintroduction of University Challenge Funds, established in 1999 to assist the successful transformation of research into business, should form part of this drive. The first round in 2000 offered universities the chance to win a Seed Fund of up to £6m to take projects to the proof of concept stage, which is by far the hardest to fund. We recommend relaunching this scheme with funding of £100m, a substantial increase from the original

£40m. Similarly we would encourage the partnering of universities applying to the fund with a venture capital firm, further developing university-business collaboration.

Aside from funding programmes, it is important to recognise the impact of demand-side policies on the development of spinout firms. Recent changes in Research and Development tax credit, in particular changes to expenditure-related deductions, have proven very helpful. The BVCA believes that tax credits should continue to be targeted at appropriate projects, however improvements to the policy could be made, specifically allowing more regular claims to further enhance cash flows for emerging businesses. Similarly we would welcome an exemption on capital gains tax on the whole cycle of emerging innovative start-ups from the transfer of intellectual property, even if the development is successful. Currently tax exemptions exist only for research academics in relation to income tax. Extending relief to promising companies directly, however, would provide a better incentive to researchers thinking about spinning out their concept, with the firm more likely to survive its first years of business with a reduced tax burden.

Start-Up Finance:

No matter how ground-breaking the concept or discovery, an idea is unlikely to be successful without first securing an initial tranche of capital to develop prototypes or bring a product to market. A shortage of this kind of investment across the country has been widely reported and highlights the need for regional cities, and their entrepreneurs, to be more attractive to venture capital investment. Taking heed of this finance gap, Governments have established several schemes to aid new firms. The Enterprise Capital Fund, launched in 2006, brings together public money with private sector funds to target investments up to £2m. Unfortunately the programme's investors are mainly based in the South and the scheme has failed to make sufficient investments across the country. Another programme, the Regional Growth Fund (RGF), launched in 2010 with £3.2bn for investment, is intended to help businesses in areas where private sector employment is low. Despite this aim, the scheme has often funded substantial loans to large firms such as Jaguar Land Rover, owned by the Indian conglomerate Tata, which increases the risk of dead-weight loss. Poor targeting of finance also occurs due to the fund's attempts to boost growth nationwide, leading it to assist firms that are unlikely to succeed in the long term. Whilst it may be less geographically expansive, the RGF should focus on providing finance to companies that have proven potential and represent a more secure investment in future jobs and growth.

The BVCA believes that a core component of any wider programme to encourage the development of our regional cities is the reinvigoration of venture capital outside of London. This in turn requires incentivising the backing of venture capital firms, particularly from institutional investors. We have long argued that there is a need for more, larger venture capital funds in order to properly support companies throughout their growth cycle - although the quest for scale must not be at the expense of regional diversity. This can be achieved by expanding the Enterprise Capital Funds and more importantly by further encouraging institutional investors such as insurance companies and pension funds to invest in venture capital. A larger investor base for UK venture capital would allow our start-ups to grow further up the funding ladder and prevent premature trade sales to overseas buyers.

Attracting institutional investors into venture capital is of vital importance, given the continuing presence of the 'equity finance gap' and the limited availability of debt finance due to the still-fragile state of the domestic banking industry. Over the last decade, the venture capital sector has become increasingly characterised by a reliance on state sponsored funds, while investment by UK pension funds in venture capital has declined sharply. This paucity of large funds and fragmentation of venture capital hampers the growth of UK SMEs in need of follow-on funding. Having institutional investors such as pension funds return to venture capital would greatly enlarge venture capital in the UK, creating broader and deeper portfolios and greater economies of scale. In addition, venture capital is an asset class that can deliver the long-term, stable returns that pension funds seek, and therefore particularly suits the longer-term nature and strategy of such investors.

As a result the backing of institutional investors would enable venture capital firms to establish substantial regional funds outside of London and the Southeast. These would connect with promising research teams which are actively seeking start-up funding and engage those that may not have considered venture capital as a means to develop and commercialise their research. Given the far greater funding that would be available compared to government schemes, the venture capital community would have the potential to back a range of companies that could develop into industry leaders, driving regional growth and the continued success of existing clusters.

Infrastructure:

Vital to the appeal of any business destination is its infrastructure. Whilst the UK was a pioneer in rail and flight, stories of our rail network and airports struggling to cope with demand alongside political wrangling over the construction of railways and runways make headlines with disconcerting frequency. Currently the only major transport projects progressing in the UK are taking place in London, with Crossrail, and in Scotland, with the new Forth Replacement Crossing. Notably, these locations are also the most politically devolved areas of the country. When completed these schemes will improve connectivity and access for businesses to their strategic partners as well as a wider pool of labour. With similar strategic investment in infrastructure between our regional cities they too will reap such benefits providing a more attractive environment for the growth of new and existing business.

The Airports Commission, led by Sir Howard Davies, is due to report in the summer of 2015 and will hopefully provide clear direction as to which of London's airports will receive new runways by 2030. The outcome of this commission will directly impact other cities given the role of London as a global transport hub. Most critically, limited airport capacity restricts the ability of airlines to serve emerging markets rendering British business poorly connected to future growth opportunities. Airports such as Charles de Gaulle serving Paris, Schiphol serving Amsterdam and the soon to be completed Brandenburg Airport serving Berlin all maintain excess capacity providing their respective nations with a competitive advantage over the UK. Similar issues exist with regard to rail provision with capacity restrained across swathes of the network. Speed is also an issue with locations such as Leeds, Sheffield and Nottingham, cities that will be central to any rebalancing of growth away from London, maintain cripplingly slow rail links. These poor transport provisions disincentivise investors and entrepreneurs from maintaining business links or establishing companies in our regional cities.

A large proportion of the priority investments required to resolve the UK's numerous infrastructure issues are expected to be met through private finance. With this in mind, the Government has helped to shape capital market solutions to enable private investors to step in such as the UK Guarantee Scheme, the Pensions Infrastructure Platform and Private Finance 2. These schemes are of paramount importance to catalyse private investments into infrastructure. In particular the BVCA is keen to explore longer-term private sector solutions through infrastructure funds and better connectivity to institutional investors. Ensuring that any outcome of the ongoing EU pensions reform (IORP Directive II) is not copied from Solvency II and does not lead to a significant reduction in the private equity investor base in Europe should also be a priority. Overarching these specific issues is a more general requirement for the government to provide long-term certainty and consistency for investors in infrastructure through programmes designed to underwrite and guarantee projects across parliaments and over long horizons. This would lower risk and reduce the cost of capital, and thus the cost for investors to partake in infrastructure projects.

The BVCA is happy to expand upon any of the points contained in this submission. In the first instance, please contact Simon Horner at shorner@bvca.co.uk.