Building an Equity Culture

Financing Growth in Innovative Irish SME’s

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IVCA
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Building an Equity Culture – Financing Growth in Innovative Irish SME's

Budget 2022 should seek to stimulate a stronger Irish equity culture and enable those with personal savings and other sources of domestic wealth to support domestic start up and scaling enterprises. We welcome the commitment in the programme for Government: Our Shared Future, to ensure a stable long term funding landscape for venture capital. Measures in budget 2022 should prioritise this aim. Now is the time to change the dominance of property as the most attractive asset class for individuals and institutions and encourage greater participation in the domestic high growth economy.

Who are the IVCA?

The Irish Venture Capital Association is the industry body for the venture capital and private equity ("VC/PE") industry in Ireland. The IVCA represents most of the Irish-based private equity and venture capital firms, as well as their investors and professional advisers.

Contribution of the industry to the Irish Economy
Over the last 25 years Government policy has enabled the creation of an active VC/PE market that leverages State investment and raises capital from international institutional investors and invests it in Irish SME's. Our members are long-term investors, typically investing in unlisted companies for around three to seven years, and are committed to building lasting and sustainable value in the businesses they invest in. This benefits the Irish economy in many ways including:

Significant investment: Over the five-year period 2015-2020, IVCA members invested over €4.8bn into over 1, 400 high potential companies based in Ireland.

Supporting jobs: Since 2015 companies backed by our members have created over 10,000 high calibre jobs in Ireland. Our members portfolio companies have grown their employee base by over 25% per annum.

Increased SME R&D Spend: Companies supported by IVCA members have on average contributed between 35%-40% of the total spend by all Irish SMEs on R&D.

Executive Summary:
We propose that in Budget 2022 Government establish an Institutional Investment in Innovative Firms Working Group to;

- Consider the availability of long-term finance for growing innovative firms looking to scale up
- Identify the long-term root causes affecting the availability of long-term finance for growing innovative firms, including any barriers that investors may face in providing long-term finance
- Review international best practices to inform recommendations for the Irish market aimed at facilitating investment in long-term finance
- Assess what changes in government policy, if any, are needed to support the expansion of long-term capital for growing innovative firms

What will the Irish economy look like in a post pandemic world? Digital Transformation and the Irish Start Up Eco System

Since the COVID-19 pandemic broke out in 2020, much of the world has moved online, accelerating a digital transformation that has been underway for decades. Ireland has a vibrant start up ecosystem which makes it well positioned to secure the opportunity that this presents. Fundraising in 2020 and Q1 2021 achieved record levels. Irish SMEs are well positioned to take advantage of the opportunities presented post Covid both locally and globally. However, a lack of additional and matching private capital is holding back the levels of growth scaling Irish firms might achieve. This gap is increasingly tempting successful growing Irish companies to scale outside of Ireland.

There is an urgent imperative to encourage private capital away from passive assets like property and direct them to fund the future of Irish Industry and the productive assets that will restore and rebalance our economy.

Why do we need to address this? How Ireland differs in available funding sources
At an individual level, Ireland has a property investing culture and not an equity investing one. Illustrating this is an analysis of Revenue Commissioners data conducted by Tech Ireland based on investment raised between 2007-2018, under four key schemes: Business Expansion Scheme (BES); Employment Investment Incentive Scheme (EIIS); Seed Capital Scheme (SCS); Start-Up Relief for Entrepreneurs (SURE). A little over €800m was secured by Irish companies through all four of these schemes – or around €8m per year. Only 27% of the funding raised went into innovative high growth potential SME's.

At an institutional level, the relatively recent nature of Ireland's prosperity and its roots in an FDI orientated open economy have resulted in a lack of depth in the type of institutional and corporate investors often seen in other European countries. There is a lack of domestic multinationals, which in other countries, typically deploy assets in domestic venture capital funds or direct investment in start-ups. For example, recent figures show that corporate venture capital activity in the United States represents @ 50% of total venture capital investment. Additionally, Ireland has significantly less well-developed family office and endowment fund structures than other European countries, and the small size or property focus of most domestic pension funds has limited investment in domestic private capital. The general trend of moving from defined benefit to defined contribution schemes has meant those of a sufficient scale to have invested in the past (An Post, RTE), find it more difficult to do so now.

Who could be mobilised to invest?

Building an Equity Culture: Increasing Institutional Investment
We believe a mechanism needs to be found to unlock far greater asset allocation from institutional providers including domestic pension funds into Irish based venture capital and private equity funds. This will ensure that existing state investment in the sector goes significantly further.

Establishing an appropriate mechanism to achieve this and enable investment by pension funds is vital when we take account of the stated Government policy of establishing an auto enrolment pension scheme.

Historically, in many countries, as well as providing for retirees in their employment the long-term savings of today's workers have been invested in businesses, providing more jobs and generating tomorrow's profits. This does not happen in Ireland as pension funds are, excluding property, investing limited amounts of their risk assets in the domestic economy. Consequently, this domestic wealth is not deployed locally, and the capital is leaking abroad, and the virtuous cycle is broken.

The UK Government created the National Employment Savings Trust (NEST), as the default home for pension contributions under auto-enrolment, it currently holds, more than £3bn from nearly seven million members and their employers. A recent analysis of the holdings in Nest's flagship fund shows that all the 10 largest holdings are in US and not UK based firms. The UK is unhappy with the limited benefit to the local economy and is addressing the situation.

Irish pension funds, including future auto enrolment funds, could make higher returns if they have the potential to invest in a wider range of assets. The UK and the US have moved to facilitate defined contribution investment in illiquid assets as they consider this a win-win scenario. The IAPF have previously expressed support for a scheme that might allow the same investment in illiquid assets in Ireland.

An emerging challenge to mobilising pension funds investment in Ireland is the concentration and outsourcing of decision making to consultant led platforms run by large scale organisations such as Mercer, Cambridge Associates, Meketa and Hamilton Lane who will only look at funds where they can deploy incredibly significant levels of capital. An underlying fund may be willing to invest in an Irish venture capital or private equity fund, but the platform manager is unwilling to conduct due diligence for less than a €50m plus ticket.

Recommendation: The commitment in the programme for Government to ensure a stable long term funding landscape is welcome and should be prioritised in Budget 2022. We propose that an **Institutional Investment in Innovative Firms** Working Group be established by the Government to;

- Consider the availability of long-term finance for growing innovative firms looking to scale up
- Identify the long-term root causes affecting the availability of long-term finance for growing innovative firms, including any barriers that investors may face in providing long-term finance
- Review international best practices to inform recommendations for the Irish market aimed at facilitating investment in long-term finance
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The group can investigate mechanisms to increase institutional investment in illiquid assets, like the work taking part in other jurisdictions.

International Comparison

In recent weeks, the UK have begun a consultation on new long-term asset fund and are considering a fund structure through which sophisticated retail investors and institutions could invest with "appropriate" confidence in less liquid assets. The aim is a vehicle that gives investors the structure they need to invest into illiquid asset classes and enables defined contribution pension schemes to manage an element of illiquid investment within their funds.

Building an equity culture in Ireland: Individual Investment

To ensure there is diversity in funding sources for Irish businesses, particularly for early-stage innovative businesses, existing schemes like EII will continue to be part of the solution. Improvements such as those suggested in our EIIS submission and the submission of the Alliance for an innovation driven recovery should be made to make this scheme a greater source of funding for innovative, risky, and high growth potential SME's rather than asset backed Irish businesses.

Additional measures to enable the population at large to invest in SME's should also be considered. Budget 2022 should seek to stimulate an Irish equity culture and enable those with personal savings and other sources of domestic wealth to support scaling enterprises, changing the dominance of property as an attractive asset class for those individuals.

For example, the introduction of an additional retail investment product like VCT in the UK, PEA-PME in France, PIR in Italy or ASK in Norway should be given consideration.

Conclusion

Ireland has a dynamic and professional venture capital and private equity ecosystem which continues to deliver for Irish SME's. The right policy interventions will support continued investment into Irish SMEs by the Irish industry

Irish policy must be shaped to further attract additional institutional and in investment into Irish venture capital and private equity funds. The next couple of years may be challenging from a fundraising perspective and both existing and new government schemes, as well as other regulatory and legislative measures, could help draw in additional capital.