Rescuing Startups: Shall we....?

The last decade has witnessed changes in the way startups are financed. Whilst at the pre-seed stage familial support (Bank of Mum & Dad) is still oft given with equity being the only option for non-asset backed projects (eg Tech), at the series B/C funding stage the 'high street' bank is also almost entirely absent from proceedings these days. Ten years on from the financial crises and armed with a mountain of government incentives in the UK at least, bank debt has mostly been replaced by equity capital / convertible notes / Government grants as the prime source of finance for the entire startup community. In the UK, the government even set up the BGF Fund in 2010, with the five leading banks each contributing £500m to build a £2.5bn equity pot to invest in companies at Series A/B/C stage in the main.

COVID-19 introduces an existential threat to this new ecosystem which, in the UK alone, has seen ca £10bn raised at 'seed' stage across more than 22,000 deals since 2011 (source: Beauhurst). Governments across Europe have been reacting with differing approaches and speed to the growing necessity to shore up finances amongst companies with neither a strong revenue nor cashflow runway. Many smaller UK start-ups will have less than one quarters cash left at current burn rates.

But some ask why save them at all? Is this not a chance to let the weak perish? Have we not embellished nascent entrepreneurs to such an extent that any Tom, Dick or Harriet now has the confidence to reach out for the financing of any unplanned dream? (there is some real dross out there!) Or do we let startups, especially at the very early stage, whither and fail at our peril?

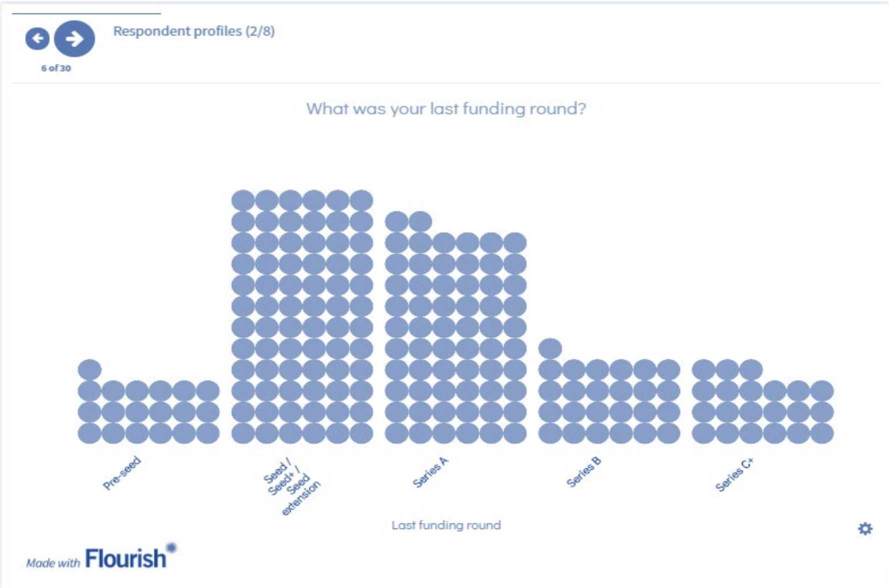
Support is coming in many different forms across Europe and with different headline amounts. This paper takes a look at the UK response and quick dive across Europe to ascertain who is promising what, and to whom, and concludes that whilst the UK government was surprisingly slow out of the blocks it has presented a scheme which, by design, means only the relatively strong are likely to receive support. This should form the basis for government involvement at 'seed' level across the continent in our opinion.

We also conclude that so called 'pre-seed' companies, those still living off the generosity of friends & family, need urgent help given they will unfortunately not qualify for government support in most countries. We believe that the 'Rescue Fund' launched this week by CapitalPilot and Seedlegals is a novel approach to bridging the cashflow gap as well as offering investors a wide spread of risk upon entry. After-all maybe a new Google or Amazon lurk within their midst?

Defining Start-Ups

Understanding the term 'Start-up' is an important prerequisite because it references different funding stages depending on the commentator. In a recently published survey entitled 'COVID-19 mitigation measures by UK startups' by VC fund Localglobe and its sister fund Latitide, the 200 'startups' who submitted responses covered the five funding stages from pre-seed to Series C+ as you can see in the graphic below.

Localglobe's Definition of Startups



For the purposes of this article we are concentrating on pre-Series A companies. This is where we anticipate the COVID pandemic to inflict the most pain and where funding solutions, from bridge to rescue finance, are urgently required to avoid a wave of bankruptcies.

In particular we are concentrating on any company that is moving out of pre-seed and into 3rd party / non-connected financing for the first time, or those companies that have been through 2-3 rounds of 3rd party seed financing, have raised up to £2m have 100k- £1m of revenues and likely not more than 20 employees.

You can lead your horse to water ....

Before looking at different responses across Europe, lets first consider the UK situation and answer why startups need government support.

Arguably the most compelling government backed scheme worldwide in encouraging equity financing of startups has been the SEIS and EIS schemes in the UK. EIS was originally set up as far back as 1994 but it was the 2012 introduction of SEIS that really changed the landscape.

In response to the lack of available startup financing in the wake of the financial crises, the UK govt set up a generous incentive for private tax payers to step in and provide new entrepreneurs with their initial wherewithal. With 50% immediate tax relief, capital gains tax deferral, no inheritance tax, and losses offset against future income tax, the SEIS scheme bought similar but even more generous advantages to the table as EIS. In 2014 it also made permanent a 'Capital gains reinvestment relief', which allows 50% relief on past capital gains where tax has been paid and if that money is redirected to SEIS qualifying investments.
As a result, many of the well healed (those in the 45% tax bracket £150K + pa income bracket) have almost religiously been 'using' their annual capped SEIS allowance of £100k where at all possible, and not least because if everything fails the downside protection has in the past been as high as 86.5% ! Today it is more likely to be between 75-78% depending on circumstances.

….and you CAN make it drink!

The impact has been colossal and has led to a consistent supply of startup capital in the UK, and hence forms the crux of both sides of the argument whether the Government should now step in and provide 'rescue financing' for the sub-sector at this time of crises.

The case against rescue?

The case against providing rescue money for startups has been given a voice by one of the senior venture capitalists in the sector. Robin Klein, founding Partner at Localglobe and known for early stage backing of Zoopla, Citymapper, Graze et al, argues that the government should be focusing its rescue efforts on those companies and freelancers that are losing revenue. His supporting evidence appears strong at first glance:

1) The startup Tech sector raised £13bn in 2019 alone. It has never been better capitalized
2) SEIS and EIS have raised more than £21bn and helped more than 42,600 companies
3) 75% of startups that raise a seed round never reach Series A ('venture stage' to many)
4) Amongst the worst performing investors, 93% of companies never progress to Series A
5) He cites that venture capital funds in the UK have more than enough capital to fund the best companies having raised $5.2bn in 2019. $2.8bn has already been raised pre-COVID in 2020
6) The 27% of companies that do make it from Seed to Series A are the least likely to need government support.
7) He argues that 'active' seed investors are working closely with the startups in portfolios
8) Many already using government furlough scheme

Flaws in the argument as presented so far

There are three key problems for us with Robin Klein's argument as presented in April:

1) He falls into the trap of not properly distinguishing between different phases of 'startup'. He explicitly ignores pre venture stage companies. This is our focus.
2) As a VC investor himself, he sees it from the perspective of a portfolio manager of a diverse range of assets that are all proven and ready to scale. He fails to see it from the entrepreneur's perspective or that of the Angel Investor, both of whom rely on the success of a single project and are not 'protected' by a wider portfolio.
3) He only references Tech and ignores everything else. According to data provider Beauhurst 1282(40%) of the seed stage deals in 2019 were non-tech companies with a combined value of £490m (25%).

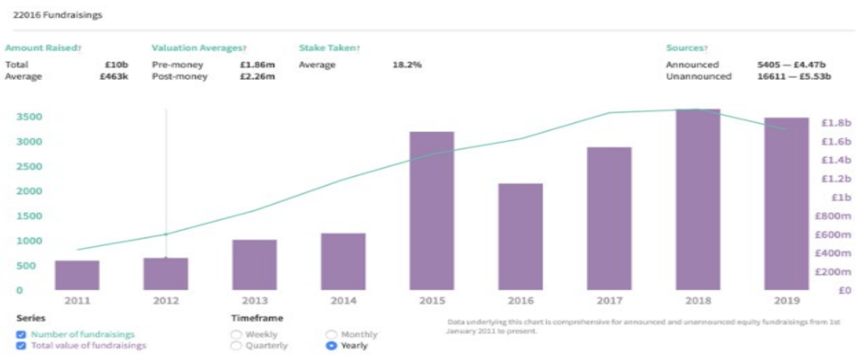
UK Govt response slow but compelling

Over the past decade the UK govt has provided a very fertile environment for startup investment, supported by generous incentives for high earners. The plan has worked and therefore in the early days of this COVID pandemic, with other European countries having rushed to show support for startups, it was surprising to us and a tad ironic given previous backing, that the UK might leave the horse with no water!

Finally, on 20th April, and after being heavily lobbied by the great and the good of the crowd and angel funding ecosystem via the Save our Startups/SOS campaign, the UK government announced a £1.25bn package of measures. £750m of the allocated funds will be provided in grants from Innovate UK the remaining £500m will come from the creation of the **FUTURE FUND**. The fund initially aims at £500m injection into startups with £250m from the government being matched by private investor backing for companies applying to the scheme. All the details of the fund can be found here and to be fair to Robin Klein (and others) who believed support inappropriate, he did say if support were given it should come in the shape of capital matching scheme.

There are plenty of aspects about this product which make sense for both Investor, Company and Government

1) It is a matching scheme. The Govt is forcing investors to sort the wheat from the chaff by deciding which companies need support with the government investing alongside.
2) It is equity but issued in the form of convertible notes and convertible at a generous 20% (or otherwise agreed) discount at the next equity raising event. The government becomes a shareholder with aligned interest, in principle at least.
3) To be eligible for a loan from the Government under this scheme, a business must be an unlisted UK registered company that has raised at least £250,000 in aggregate from private third party investors in previous funding rounds in the last five years and have a substantive economic presence in the UK. The chart below shows that the average raise over ten years at seed stage is £463K so many are captured in the net.



4) The amount that can be raised from the govt side is between £125k and £5m, inferring that a company could raise as much as £10m if matched private investors were willing. This fund therefore captures all stages of the startup ecosystem but importantly dips down to companies that will be rapidly be burning the first relatively small funds raised and providing a crucial lifeline. It also forces existing investors in the company to think to what extent a company is worth pursuing. We think this is very healthy for the whole system and will implicitly improve the portfolio quality at VC stage down the line.

Are the smallest still being left out?

The BBB has been put in charge of not only the Future Fund but also the earlier announced Coronavirus Business Interruption Loan Scheme (CBILS). This is the scheme that provides loans to businesses that are more established and where revenue has been lost during COVID. With the two schemes the govt is now offering a safety net to all but the most nascent start-ups. Excluded therefore are those companies presenting a minimum viable product (MVP), where the idea is still in early development or where funding has only been provided by friends and family, or where 3rd party funding has not reached the £250K threshold. These businesses are almost invariably pre-revenue, pre profit with rarely more than 3 full time staff/founders.
Capital Pilot believe this sector of the economy possibly includes ca 25,000 companies and meet promising companies in this subsector regularly.
Whilst there can be some sympathy with the view that in times of crises the Government's first duty/priority must be to those companies making an economic contribution and by definition supporting more collective employment, that simply won't wash with the entrepreneur who believes his/her idea is the next Shazam, Spotify, Airbnb or Fever Tree.

We believe that just because the government has not led this horse to water (often pre SEIS), there is still a very solid argument for saving these nascent companies and providing support. Every company has been at this stage and in Europe we will need all the entrepreneurial flare and endeavour possible after the crises.

Introducing the Rescue Equity Fund from Capital Pilot & Seedlegals

In response to slow government moves in the UK to provide a solution for startup financing during this crises, Capital Pilot Ltd, which sets out to lower startup investment risk by applying a proprietary rating system (a 'Fitch' for startup equity risk if you will) have teamed up with Seedlegals, the highly regarded one-stop platform for all the legals required to start a funding round, and have created the RESCUE EQUITY FUND.
In fact, whilst this has been set up in response to COVID-19, we believe it actually performs a necessary function of putting investor money to work more efficiently and with much less risk at hand.
Since Wednesday 6th May, Capital Pilot are inviting companies to pre-register for the scheme which is currently at the funding stage. The idea is to raise £50m and to invest £50k in 1000 investable companies that meet the investable criteria of the Capital Pilot rating system.
Inbound Capital would be happy to introduce both companies and investors to this important initiative if possible.

That is the UK covered – what about the rest of Europe?

It was noteworthy to us that other European countries, notably France, Germany and Switzerland were all faster out of the blocks to offer government assistance to startups than we were here in the UK. This is despite the fact that the UK dwarfs other markets in terms of committed capital and the plethora of government incentives available as discussed already.

We have a definite sense of some creeping underlying competition in this Brexit world, which we intend to explore in more detail in future updates. One is left with a sense that the continent is fast waking up to the necessity to feed their start up ecosystems with capital and knowledge.

We will keep an eye on further measures being announced in upcoming months but for now the table below highlights some of the measures already seen across the wider EU. I have included a link to each country's main source of information on this topic. Some of the headline figures do not compare apples with apples, eg the Swiss figure of SFR40bn clearly incorporates a loan scheme for established companies as well. Drilling down into the detail is time consuming and that detail is still quite opaque. We will attempt to tackle this in future updates.

Robin Maxwell

	Key source of information	Cash Injection from Govt	Govt Loan Scheme	Furlough Scheme	Social Payment deferral	Tax Deferral	Debt Payment issue	Other
France	La French Tech	Yes €4bn	Yes via BPIFrance	Yes	Yes	n/a	State mediator	Utility Bill Deferral Scheme
Germany	BV Deutsche Startups	Yes €2.2bn Bailout	Unlimited via KFW	Yes	n/a	Yes	n/a	Bankruptcy law change
Italy	Italia Startups SOS	n/a	Yes via Cassa Depositi	No	Yes	Yes	Mortgage Deferral	One off €600 pay for self employed
Spain	Barcelona Tech	100% SME Support	Loan Payments postponed	No	n/a	Yes upto €30k	n/a	
Ireland	Scale Ireland	n/a	Yes via MicroFinance Ireland	Yes	n/a	Yes	Help upto €1m	€200m WCapital scheme
Portugal	#tech4covid	€25m	€200m Credit for Wcap	Yes	n/a	Yes	n/a	€60m for microbiz in Tourism
Sweden	Ministry of finance	n/a	SEK500bn via Riksbank	Yes	Yes	n/a	n/a	2mth Sick Pay
Denmark	Copenhagen Capacity	n/a	DKK 60bn in guarantees	Yes	n/a	n/a	n/a	Budget for large scale layoffs
Norway	Oslo Business	NOK 50bn (90% g'tee)	n/a	n/a	n/a	Yes	n/a	n/a
Finland	Bank of Finland	n/a	Unemployment scheme	n/a	n/a	n/a	n/a	n/a
Austria	Austrian Eco Chambers	€38bn in total	Yes via Wirtschaftservice	Yes	n/a	Yes	rent subs	Loans for Tourism SME's
Netherlands	Dutch Chamber of C	n/a	€750m credit scheme	Yes	Yes	Yes	n/a	n/a
Belgium	Fed Govt	€233m rescue fund	monthly bridging grant	n/a	n/a	n/a	n/a	n/a
Switzerland	FT.com	n/a	SFR 40bn in total	Yes	n/a	n/a	n/a	Start up Support
UK	UK Govt	€1.25bn	Yes via British Business Bank	Yes	Yes	n/a	Deferral Scheme	n/a

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