High Growth Small Business

Report 2019

octopus

A brighter way

HIGH GROWTH SMALL BUSINESS

2019

HGSBs defined

We define high-growth small businesses (HGSBs) as those with annual average growth of more than 20% over a three-year period and an annual turnover of between £1 million and £20 million.

Foreword

The UK is renowned for its culture of entrepreneurship and is rightly ranked as one of the best countries in the world in which to start a business. British high-growth small businesses (HGSBs) are pioneers, innovators and experts in their fields. They continue to punch well above their weight through their economic contribution, and we think this is cause to celebrate.

Political uncertainty over the UK's future trading relationships and disruption from new technologies – including artificial intelligence and the increasing pace of digitisation – pose challenges for business. HGSBs are at the forefront of meeting these challenges.

We welcome the support that the Government has provided for small businesses in recent years, particularly from the Department for International Trade in championing their interests abroad. As shown in the Patient Capital Review in 2017, recent Government policy has helped to increase the supply of capital in order for small businesses to expand. Helping investors to confidently back HGSBs will allow them to grow into the FTSE 100 businesses of the future.

At Octopus, we are proud of our track record of investing in some of the UK's most exciting, innovative small businesses. We are pleased to be able to highlight their work in this, the fourth High Growth Small Business Report.

Chris Hulatt
Founder, Octopus Group

Find it fast

Executive summary

It is clear that HGSBs are now, more than ever, vital to the success of the UK economy. This report highlights the large economic contribution these businesses make, in particular their role in job creation and global trade

According to data from the Office for National Statistics, HGSBs added around £113 billion to the UK economy in 2016/17, despite making up less than 3% of all businesses. HGSBs also help to drive productivity across the UK, making their greatest contribution to regional economies outside of London – Northern Ireland in particular.

But HGSBs make their biggest impact through job creation. Leading innovation in sectors such as construction, finance and technology, HGSBs generated an impressive 84% of net employment growth in 2016/17, creating the high-skilled jobs of the future.

We surveyed 200 HGSB leaders on their growth prospects, concerns and attitudes to trade. They are optimistic about the UK economy, but also global in their outlook. HGSBs are keen to increase trade to markets such as the USA and China, which will be of added importance after the UK leaves the EU.

When it comes to employment, HGSBs rely on being able to recruit the skilled workers they need to expand, many of whom come from the EU. We asked HGSBs of their biggest apprehension about Brexit, and access to talent was consistently cited as a dominant concern.

This report's findings show the pivotal role HGSBs have to play in a successful economy, but these businesses do not thrive without the financial support to invest and grow. At Octopus, we have 19 years of experience in helping small businesses to scale up, supporting them with capital investment and business advice. However, without support from the Alternative Investment Market (AIM) and targeted incentives for investors, HGSBs would struggle to find the patient capital investment that enables them to expand.

As our recommendations show, the success of HGSBs is made possible through the policies that successive governments have introduced. We urge policymakers to continue to incentivise investment in innovative, fast-growing small businesses and champion their interests across all policy areas, particularly employment and trade.

84%

of net employment growth in 2016/17 was created by HGSBs

HGSBs at a glance

We define high-growth small businesses (HGSBs) as those with annual average growth of more than 20% over a three-year period and an annual turnover of between £1 million and £20 million[i]

A small group

77,646

HGSBs are a select group. Latest figures show that there were 77,646 in 2016/17, representing just 2.9% of UK businesses.

Job creators

1.9m

HGSBs employ around 1.9 million workers and accounted for 84% of net employment growth between 2016 and 2017.

Driving the economy

£113bn

HGSBs are among the UK's most productive businesses, contributing £113 billion in gross value added (GVA) to the economy in 2016/17.[ii]

Concerns

1 in 3

Over a third of HGSBs want the Government to reform business rates, which are a significant financial pressure when running a small business.

Investing in the future

£1.2bn

Octopus manages over £1.2 billion in venture capital investment, helping to support more than 500 smaller businesses to grow.

SUPPORTING HGSBs

HGSBs differ from other SMEs and face specific challenges. Policymakers should note the unique factors that contribute to HGSBs' success and support them to start up and grow for the benefit of the UK economy.

Chapter 1: What makes HGSBs so special?

Innovative, diverse and productive, HGSBs create skilled jobs and make a vital contribution to regional economies across the UK

24%

In 2016/17, HGSBs were 24% more productive than low-growth small businesses (LGSBs)

What makes HGSBs so special?

HGSBs are essential drivers of growth in the UK economy, punching well above their weight in terms of their economic contribution, productivity and job creation

HGSBs are incredibly diverse and cover a range of sectors, from technology and financial services to manufacturing, construction and food and drink. They also exist in all regions of the UK, helping to spread economic prosperity across the entire country.

While HGSBs are already a UK success story, there is much more that can be done to unlock their full potential. This means ensuring they have the skills base they need to succeed and the investment to grow and scale up over the long term.

What makes HGSBs different?

HGSBs are a unique segment of the UK business community. In 2016/17, they represented just 2.9% of registered businesses in the UK. While this share has remained largely consistent since 2015, HGSBs are constantly evolving and changing; of those businesses classed as or on course to be HGSBs in 2016/17, almost half (49%) were created since 2015/16.

Comparison with LGSBs

HGSBs are among the UK's most productive businesses. In 2016/17, they were 24% more productive than those classed as low-growth small businesses (LGSBs).[iii] This means the average HGSB worker generates significantly more turnover than the average LGSB worker.[1]

Of course, HGSBs are so called because they grow much faster than other businesses. As figure 2 shows, businesses that were HGSBs in 2016/17 increased their turnover by £80 billion between 2015/16 and 2016/17.

Driving economic growth

Where HGSBs really make an impact is in their contribution to the economy, driving growth across the UK. In 2016/17, they contributed an estimated £113 billion in gross value added (GVA) to the economy.[2]

The strength of HGSBs is also shown in their diversity. While the success of start-up businesses in the technology and financial services sectors is well known, these fast-

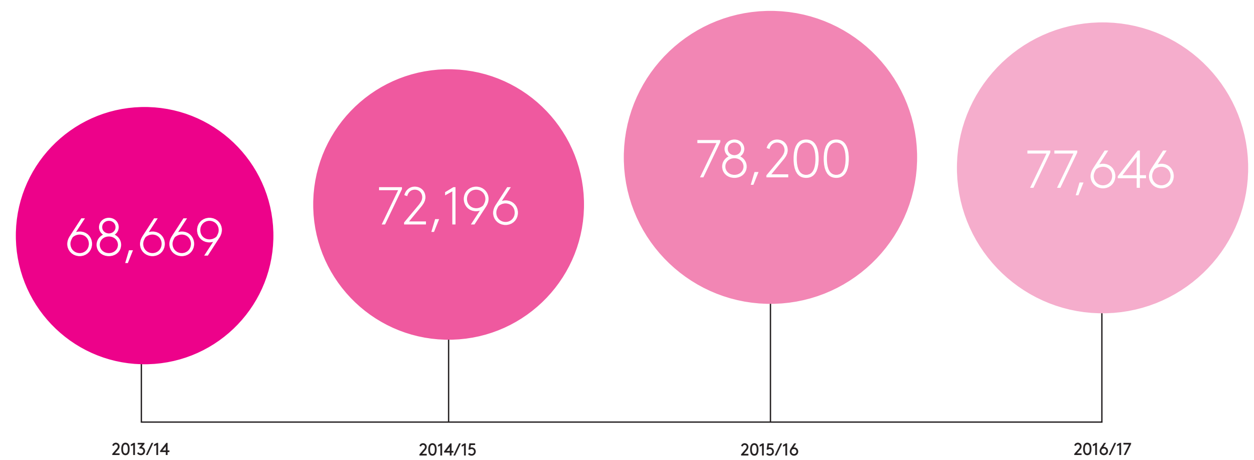
2.9%

of UK businesses in 2017 were HGSBs

49%

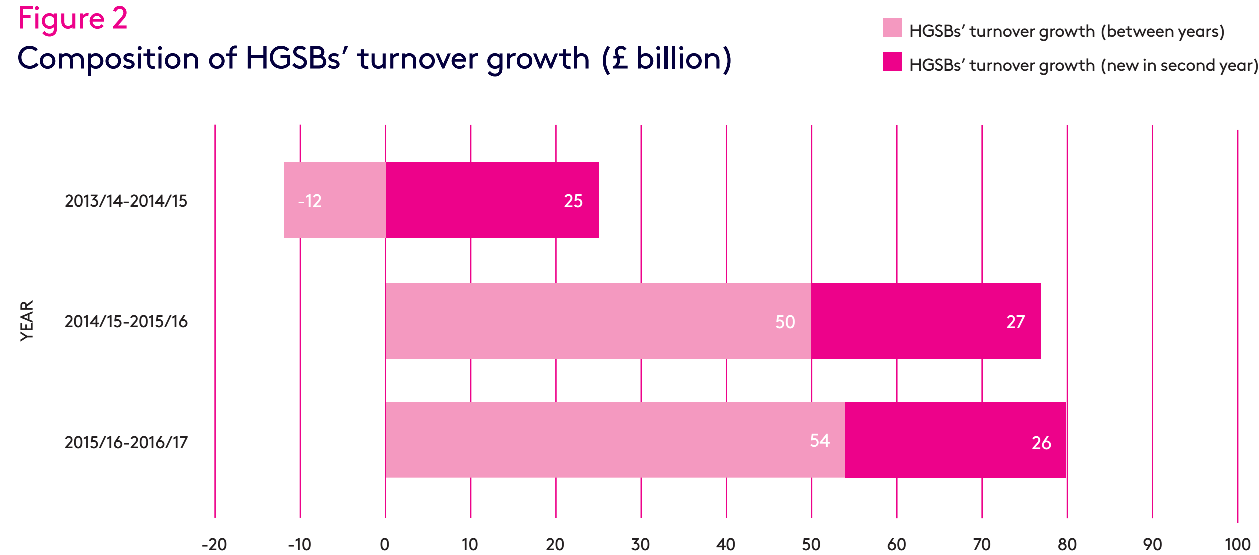
of HGSBs in 2016/17 were created since 2015/16

Figure 1
Total number of HGSBs in the UK



Source: Frontier analysis of ONS data (Business Structure Database), Business Population Estimates

Figure 2
Composition of HGSBs' turnover growth (£ billion)



Source: Frontier analysis of ONS data (Business Structure Database)

Note: 2013/14 refers to the 2015 Business Structure Database, 2014/15 refers to the 2016 Business Structure Database, 2015/16 refers to the 2017 Business Structure Database, 2016/17 refers to the 2018 Business Structure Database. BPE estimates not included as no data on turnover for financial services are available

Where HGSBs make an contribution to driving whole of the really impact is in their the economy, growth across the UK

Figure 3
HGSBs by industrial sector in 2016/17

1 Construction
20.2%

2 Wholesale and retail trade
18.8%

3 Administrative and support services
12%

4 Professional, scientific and technical
11.6%

5 Information and communication
6.5%

6 Manufacturing
6.3%

7 Human health and social work
4.5%

8 Accommodation and food services
4.3%

9 Real estate activities
3.3%

10 Transport and storage
2.8%

11 Finance and insurance
2.4%

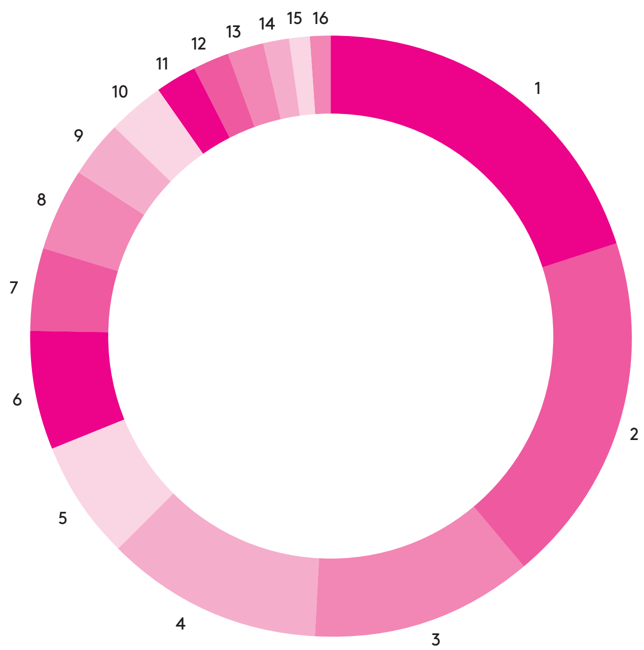
12 Mining, electricity and gas, water and sewerage
1.9%

13 Arts, entertainment and recreation
1.8%

14 Agriculture, forestry and fishing
1.5%

15 Education
1.1%

16 Other service activities
1%



Source: Frontier analysis of ONS data (Business Structure Database)

Note: 2016/17 refers to the 2018 Business Structure Database

growing businesses cover a broad range of sectors, with construction and wholesale/retail trade the two sectors with the highest number of HGSBs (see figure 3).

Regional footprint

HGSBs make invaluable contributions to local economies in all regions of the UK. While London has a higher proportion of HGSBs than elsewhere, HGSBs make a larger relative economic contribution in other regions. In Northern Ireland, for example, HGSBs contribute a greater percentage of regional turnover and GVA than in London (see figure 4).

Like all businesses, HGSBs face various financial pressures, from the availability of capital to the burdens of regulation and business taxation. Small businesses feel these pressures more acutely than larger ones, and of the 200 HGSB senior executives we surveyed, 35% said that cutting business rates would be the most helpful intervention the Government could make to support their businesses, many of which occupy physical premises.[3] Many entrepreneurs also raised the arduous process of applying for business rates relief, which can be particularly costly and time-consuming for small businesses.

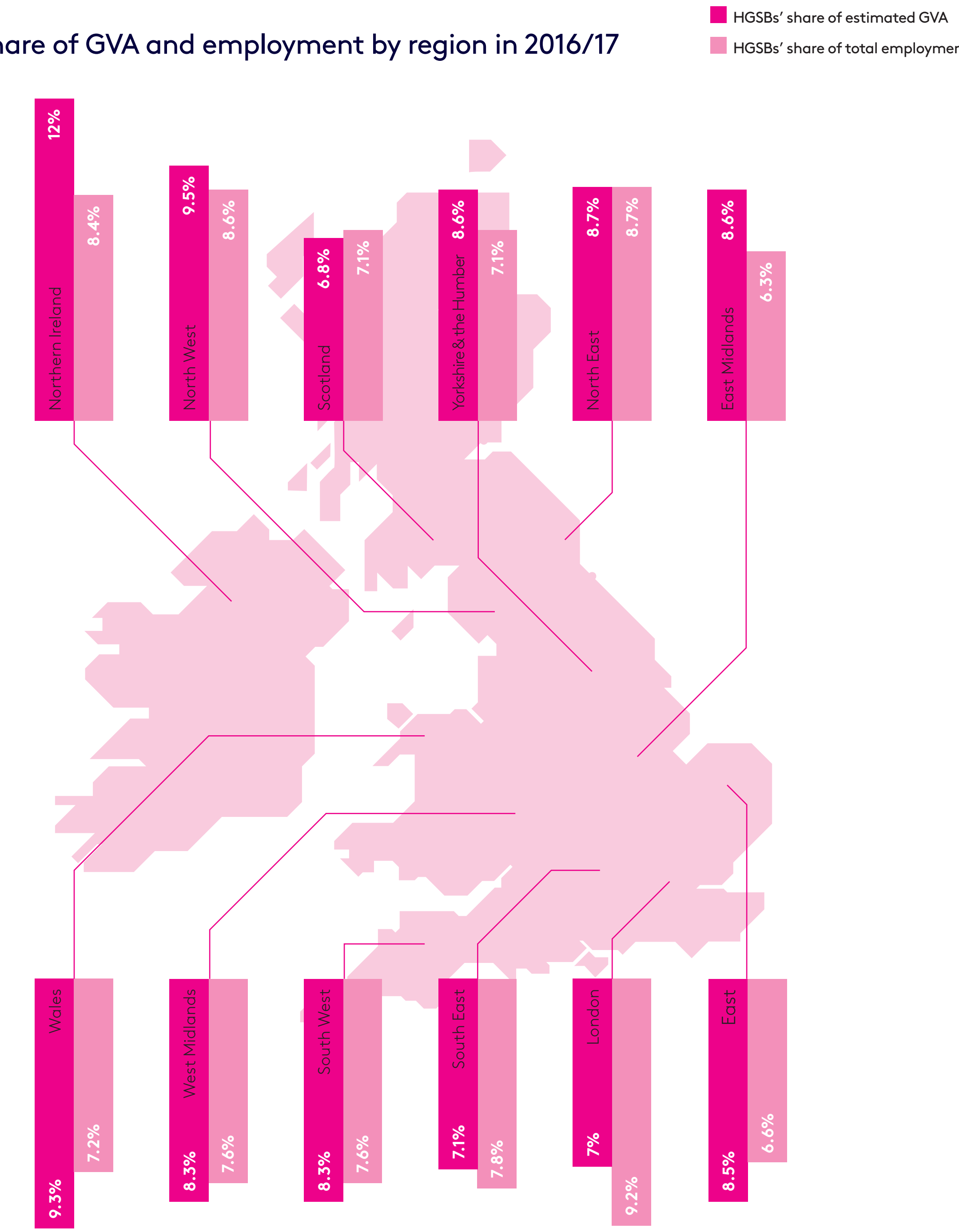
Recommendation: Reform the business rates system

HGSBs are diverse and cover a broad range of sectors, from financial technology to manufacturing – and, like many other businesses, face a variety of tax pressures.

Our survey has found that while corporation tax is a significant pressure, entrepreneurs cited business rates as the area of the tax system where the most urgent reform is needed. Over a third said that cutting business rates is the best way the Government can support the growth of their businesses.[4]

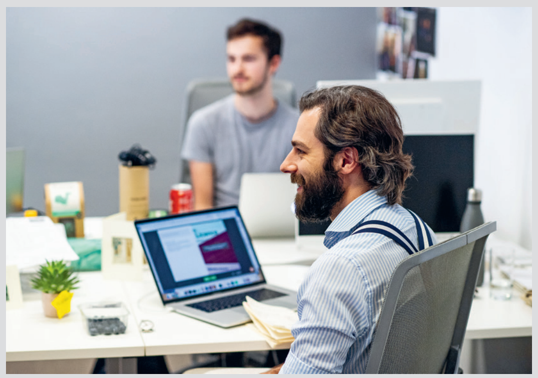
The business rates system unfairly penalises bricks-and-mortar businesses and stifles the growth of HGSBs. *The Government should reform the outdated business rates tax by moving to a new system that addresses the current imbalance between business profits and physical property values.*

Figure 4
HGSBs' share of GVA and employment by region in 2016/17



Source: Frontier analysis of ONS data (Business Structure Database), ONS Annual Business Survey

Note: 2016/17 refers to the 2018 Business Structure Database. BPE estimates not included as no data on turnover for financial services are available. Figures are estimates of GVA using turnover multipliers at sector and size level estimated from Annual Business Survey and National Accounts data. Measures headcount employment (jobs) rather than full-time equivalents



Case study

Runway East

CEO Natasha Guerra explains the challenges she faces as a small-business leader

Runway East is an HGSB that provides start-ups with state-of-the-art office space, as well as the support and connections that they need to grow. Founded in 2014, the company helps an ever-expanding community of 1,800 members work faster, smarter and happier from four Runway East spaces across London and Bristol.

Discussing the obstacles she faced when starting her business, Natasha Guerra, CEO of Runway East, says: "What made it really challenging to start was that a lot of the systems we interact with are just so archaic." As an example, she cites how it took a long time to agree property leases.

Natasha also highlights the bureaucracy and cost involved when dealing with the Government. "Business rates have made property really difficult," she says. "It's such an old system which really doesn't value the right people; it doesn't benefit people in the right way.

"What gets to me most is that I have to employ someone for our business rates negotiations. I pay a person a salary just to interact with the Government about something that should be really simple. It's really time-consuming to get the business rates discount that you're owed."

> "Business rates have made property really difficult"

RUNWAY EAST

1.9m
workers were employed by HGSBs in 2016/17, representing
7.8%
of workers in the UK job market

Creating the jobs of the future

HGSBs are among the most innovative, knowledge-intensive businesses and make a huge contribution to job creation.

In 2016/17, HGSBs employed 1.9 million workers, which represented 7.8% of the UK job market.[5] Of the 488,000 recorded net employment growth between 2015/16 and 2016/17, HGSBs accounted for an impressive 84%.[6]

These businesses create vital skilled employment and are essential to the future labour market. However, with the current labour market operating at near capacity, HGSBs say they are struggling to recruit the talent they need.

Recommendation: Expand the apprenticeship levy to create a 'skills levy'

It is not sustainable for the UK to import talent from elsewhere without addressing the domestic skills shortage. A priority should be upskilling the UK's workforce in order to adjust and develop the technologies, sectors and jobs of the future. Addressing the skills gap cannot be considered in isolation – there must be a holistic approach, spanning from primary education to retraining on the job.

While we welcome the Government's commitment to improving and expanding core technical routes of education and training, demonstrated by the introduction of the apprenticeship levy and T-levels, more can be done to ensure businesses can hire people with the skills they need.

Few companies take full advantage of the funds made available through the apprenticeship levy in its current form, so it is therefore less efficient at achieving the goal of reducing skills shortages than it could be. *By expanding the apprenticeship levy into a more flexible 'skills levy', it would reach a wider pool of recipients and enable the critical upskilling and retraining that many people in the labour market require.*

Initially, the Government could tie this new levy to the Industrial Strategy Sector Deals, which identified the sectors that are of strategic importance to the UK beyond Brexit, before rolling it out in sectors that face the largest skills shortages.

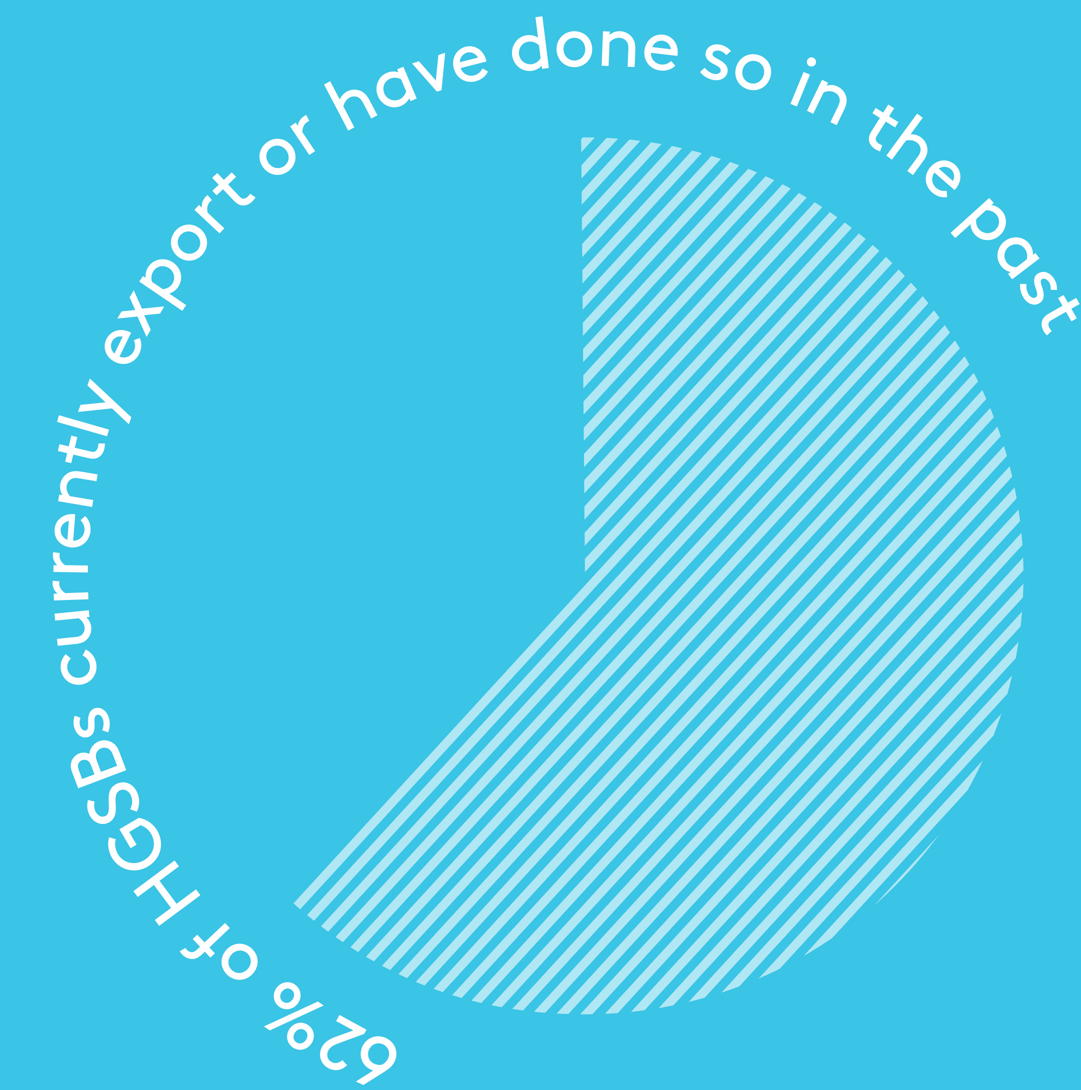
Recommendation: Careers services should partner with local HGSBs through a national entrepreneurs' mentoring scheme

Careers advice in schools and universities focuses on traditional professions such as medicine, finance and law. But the world of work has moved on: HGSBs now provide a sizeable proportion of jobs, and there are more entrepreneurs than ever before.

For those aspiring to start their own business, the advice and support available through traditional education is almost non-existent. *We recommend encouraging school and university careers services to partner with local HGSBs through a national mentoring scheme* to connect aspiring entrepreneurs with experienced businesspeople. This could operate on an online platform that would also include testimonials from entrepreneurs, as well as information about Government support available for start-up businesses.

Chapter 2: HGSBs’ place in Global Britain

HGSBs are optimistic about their potential for growth – but they need a stable economy at home in order to succeed in the global marketplace



HGSBs' place in Global Britain

The UK is one of the best places in the world in which to start a business and has, until recently, boasted consistent GDP growth, helping to attract inward investment

In a 2018 report by Imperial College London, the UK ranked fourth in the world for entrepreneurship, while UN figures show that the UK remains the leading destination in Europe for foreign direct investment.[7 8]

Strength of the UK economy

HGSBs are generally optimists and determined to succeed. Working tirelessly to start their own business, entrepreneurs are naturally upbeat about the success of their enterprise.

Responding to our survey, 70% said that they are optimistic they will maintain their current level of growth over the next three years (see figure 5). This positivity is also shown in their outlook on the UK economy: 45% said that they are optimistic about the economy over the next five years, whereas only 29% are pessimistic (see figure 6).

The UK has a strong reputation for entrepreneurship. Between 2013 and 2016, the UK economy grew consistently above the G7 average. Supported by targeted reductions in taxation, this has made the UK an attractive destination to start a business.[9]

However, since the EU referendum in June 2016, the UK's economic growth has slowed to the lowest in the G7. Political uncertainty following the vote to leave, including over what form Brexit will take, has affected business confidence.[10] Despite the optimism of HGSBs, when asked what their main concerns were about their growth prospects, "political uncertainty" and "a sluggish economy" were the two most common responses (see figure 7). A stable business environment is essential for HGSBs to realise their potential.

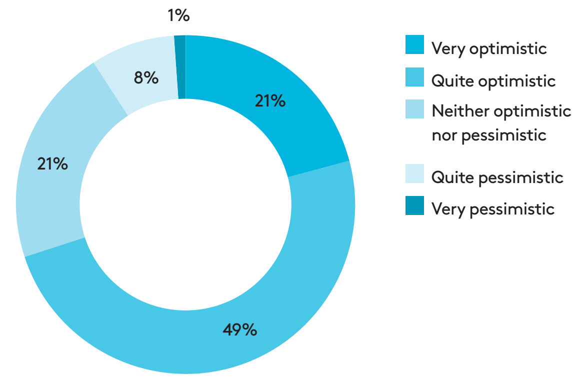
HGSBs and global trade

A successful economy is underpinned by a strong international trading presence. The UK has a proven track record of exporting: British exports grew faster than those in Germany, Italy and France between 2016 and 2018, according to the OECD. As the UK leaves the EU, the Government has made it clear that it intends to increase exports to other global markets, including the USA and Asia.[11]

HGSBs make a crucial contribution to UK exports and are important partners in achieving this ambition. Of the businesses we surveyed, 62% currently export or have done so in the past.[12]

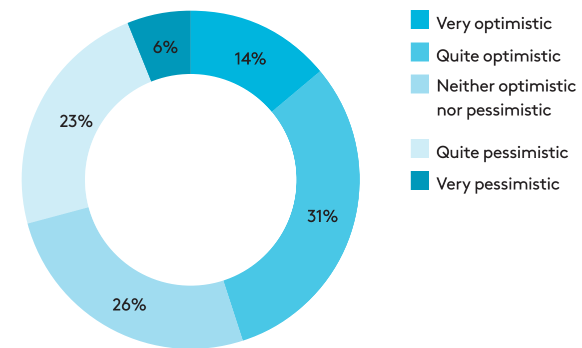
Furthermore, these exports are focused on key growth markets, many of which are the leading destinations for venture capital

Figure 5 HGSBs' optimism that they will maintain their current rate of growth over the next five years



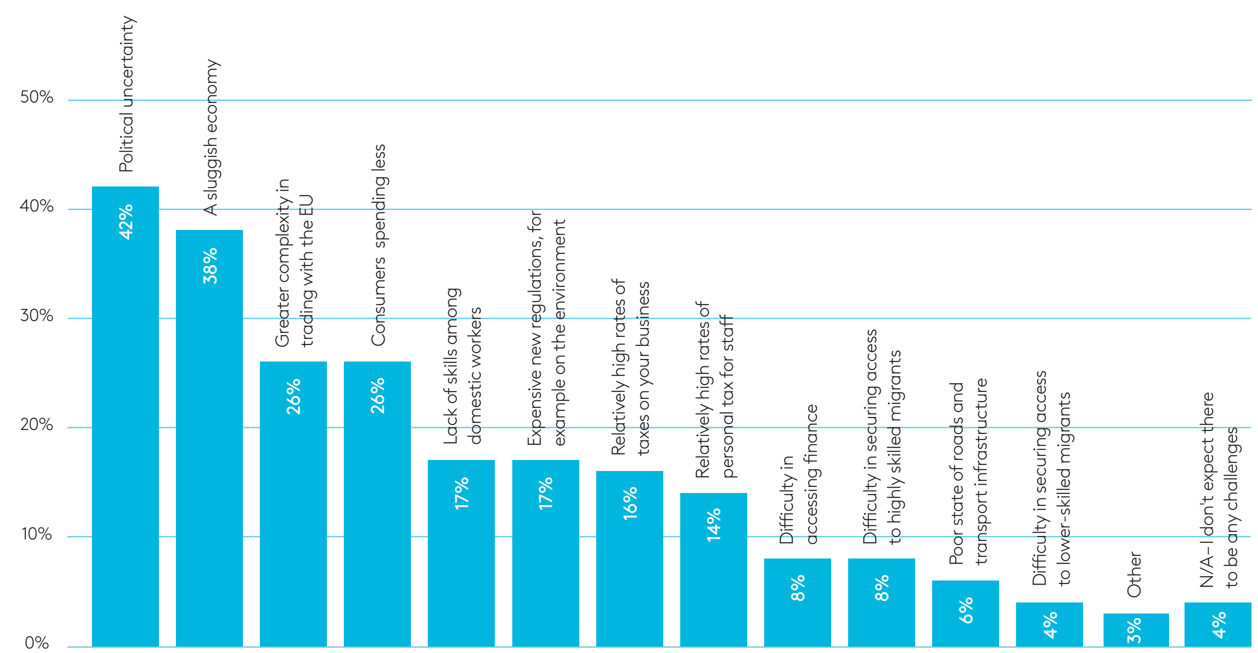
Source: Public First/Opinium research

Figure 6 HGSBs' optimism about the likely state of the British economy over the next three years



Source: Public First/Opinium research

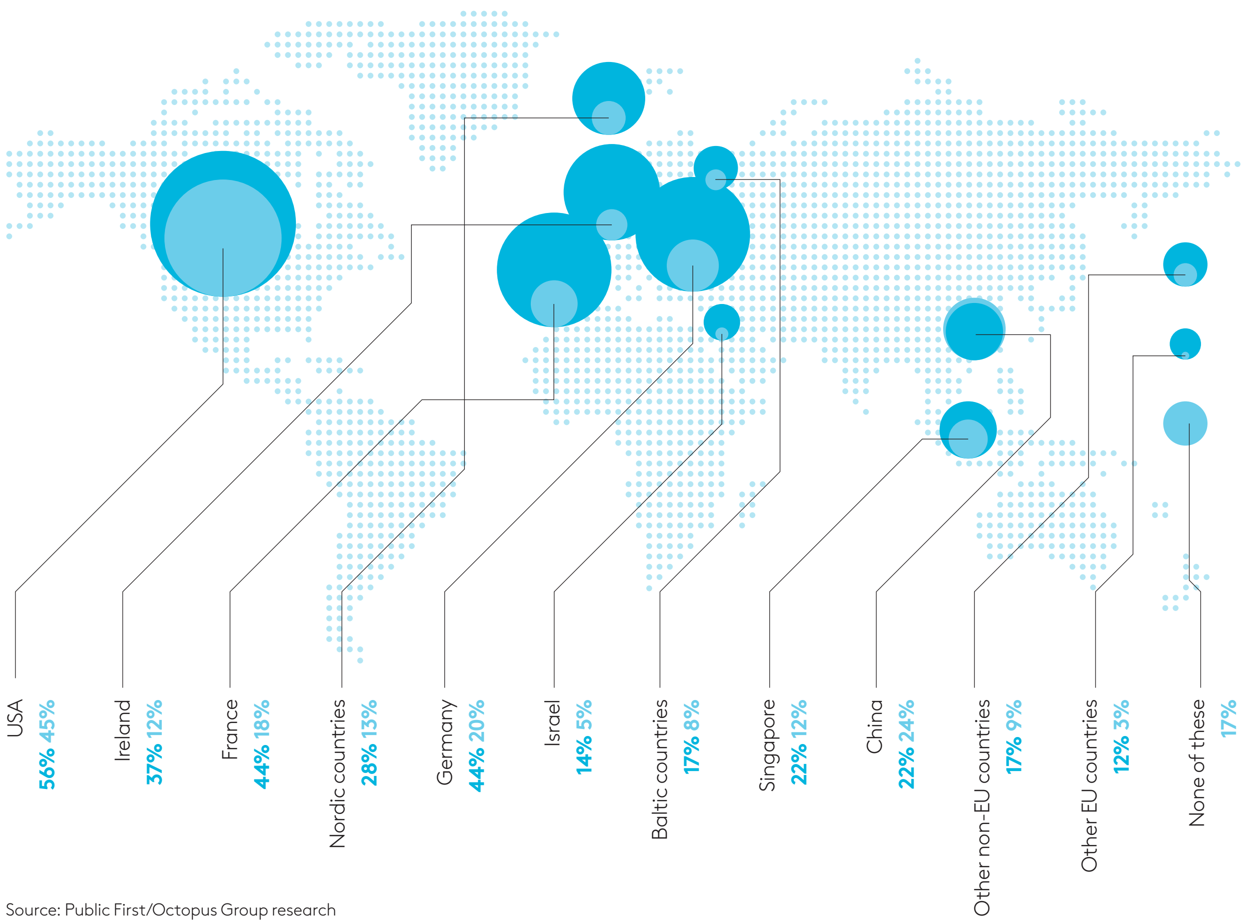
Figure 7
The biggest challenges to HGSBs' continued growth in the next few years



Source: Public First/Opinium research

Access to emerging markets is essential for HGSBs to grow and for the UK economy to thrive post-Brexit

Figure 8
HSGBs' key export markets



Source: Public First/Octopus Group research

investment, such as the USA and China.[13] The top destination for exports from HGSBs we surveyed was the USA (56%). Similarly, when HGSBs were asked where they would like to increase exports to, the top answer was the USA, followed by China (see figure 8).

Access to these markets is essential for HGSBs to grow and for the UK economy to thrive post-Brexit. It is important that the Department for International Trade (DIT) continues to support HGSBs to expand by promoting their trade interests abroad.

Recommendation: The Department for International Trade should convene a small-business working group to champion the interests of HGSBs

HGSBs trade all around the world and have a strong presence in markets such as the USA and China. We know that being able to trade is vital for HGSBs to grow and welcome DIT's support. We urge DIT to continue to include venture capital trust (VCT) fund managers and portfolio companies in future trade delegations, particularly in Asia and the USA.

With the UK looking to increase global trade after it leaves the EU, it is crucial to promote trade in all areas of the economy. Future trade deals struck by the department will govern HGSBs' trading arrangements, so it is important that the interests of entrepreneurs and small businesses are represented. *DIT should appoint a dedicated minister for small businesses to chair a working group of SMEs, ensuring that they are given a voice in future trade negotiations.*

Challenges of Brexit

HGSBs benefit from free trade with the EU, which is the UK's largest trading partner. The businesses we surveyed told us that after the USA, France and Germany were the next two largest export destinations. Though HGSBs are optimistic about the UK economy, losing tariff-free trade with the EU would have a negative effect. Furthermore, the EU is an important supplier of capital for HGSBs to grow – the European Investment Fund (EIF) has invested billions of pounds in UK SMEs through multiple venture capital and growth funds.

The Government's Infrastructure Finance Review is looking at how the UK addresses withdrawing from the European Investment Bank, the EIF's majority investor, after it leaves the EU. Institutional investment in venture capital is crucial to enable HGSBs to grow, so the Government should ensure that there is no shortfall in growth capital for these businesses.

Recommendation: British Business Bank should replace and exceed venture capital commitments by the European Investment Fund

The EIF has been an important provider of growth capital for HGSBs. Between 2011 and 2015, it invested around €2.3 billion into UK venture capital, growth and mid-market funds, which then supported a total investment of €13.8 billion into SMEs.[14]

It is clear that the Brexit vote has already resulted in a drop in funding from the EIF

Case study

Unilink

CEO Francis Toye says access to talent is crucial to the success of his business

The award-winning UK SME Unilink has been a leading secure software provider for more than 25 years, with expertise in biometrics and criminal justice applications. The company designs and develops innovative software solutions for the police, prisons and probation services in both the Government and private sectors.

Discussing the biggest challenges facing his business, Francis Toye, CEO of Unilink, says: "The number one issue is recruitment and finding the right people. For us, the Government's role there is training people and giving them the skills and talent.

"The UK is massively short of software developers, and there's no sign of it getting any better."

> "The number one issue is recruitment and finding the right people"

for UK venture capital and HGSBs. Through its Infrastructure Finance Review, the Government will be acutely aware of the contribution that EU financing institutions make to the UK economy and the need to maintain current levels of investment.

As the UK leaves the EU, the Government should ensure that British Business Bank maintains, but also looks to exceed, the historic funding levels provided by the EIF.

€2.3bn

invested by the European Investment Fund into UK venture capital, growth and mid-market funds between 2011 and 2015

Access to talent

Our survey highlighted some concern about the potential loss of easy access to the most talented people (19% of HGSBs cited this as a potential problem – see figure 11), and it emerged as a key issue in our interviews with business leaders. The UK labour market is operating at capacity and there is a shortage of skilled domestic talent, particularly in the tech sector.

A high proportion of HGSB employees are from the EU, so without access to skilled European talent, HGSBs would struggle to recruit the workers that they need to grow.

Having access to talented staff is central to the success of new businesses. When asked which factors contributed most to their businesses' success to date, the top answer among entrepreneurs was "we have great staff" (see figure 9).

Although more can be done to upskill the domestic labour force, this will not be able to meet the demand for talent, certainly in the short term. With the UK set to lose freedom of movement, the Government should make sure that businesses can access the skilled talent they need from both outside and inside the EU.

The Home Office and the Department for Business, Energy and Industrial Strategy are reviewing the visa system, which will apply to EU nationals once the UK leaves the bloc. As part of this, the Government should reform the current tiered visa system to allow HGSBs to recruit the workers they need and help to attract entrepreneurs to the UK.

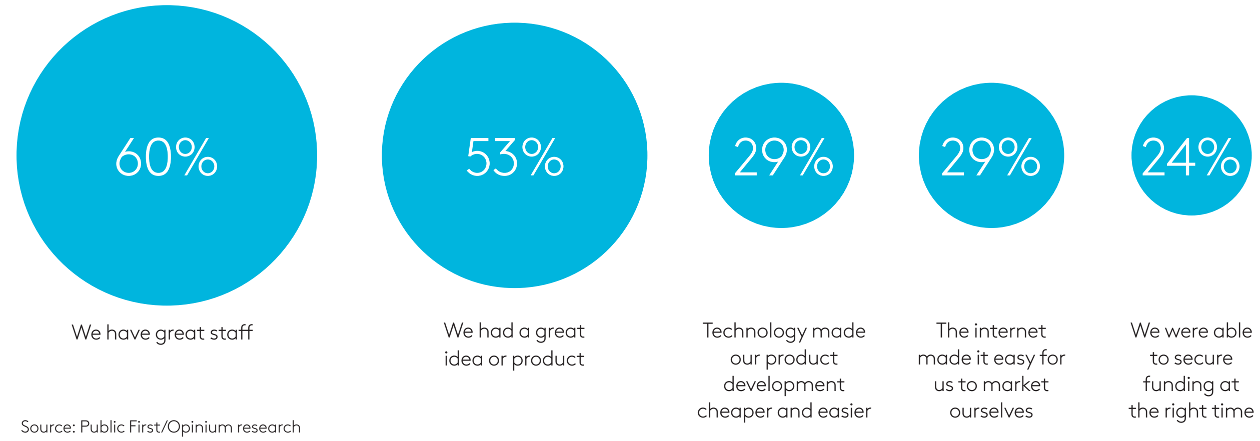
Recommendation: Create 'talent visas'

HGSBs frequently cite skills shortages as a barrier to growth. The UK should ensure that HGSBs are able to access the best global talent – whether from the EU or further afield. One way to ensure that the door remains open is to create a visa system that does not penalise people based on their salary, but assesses their ability to contribute to the UK's business environment more broadly, by introducing 'talent visas'.

To guarantee access to the most skilled workers the world has to offer, *we recommend that the Home Office reviews its visa system relating to highly skilled jobs in the UK*, as the current visa regime (Tier 1 and Tier 2) is not fit for purpose.

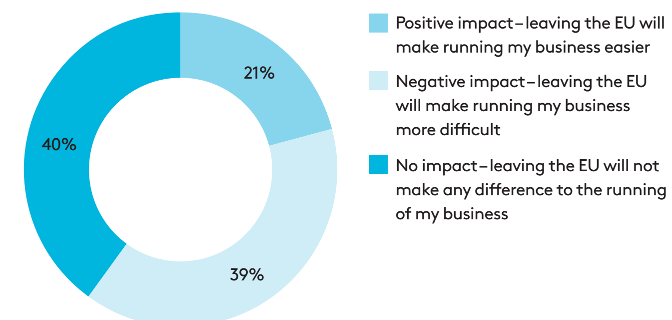
In the short term, the Home Office should remove salary requirements for highly skilled entrepreneurs from Tier 2 visas to make it easier for HGSBs to access talent as the UK leaves the EU. Visa applications should be assessed on the basis of skills and the value an individual could bring to a business.

Figure 9 Top five factors HGSBs say contributed most to their success



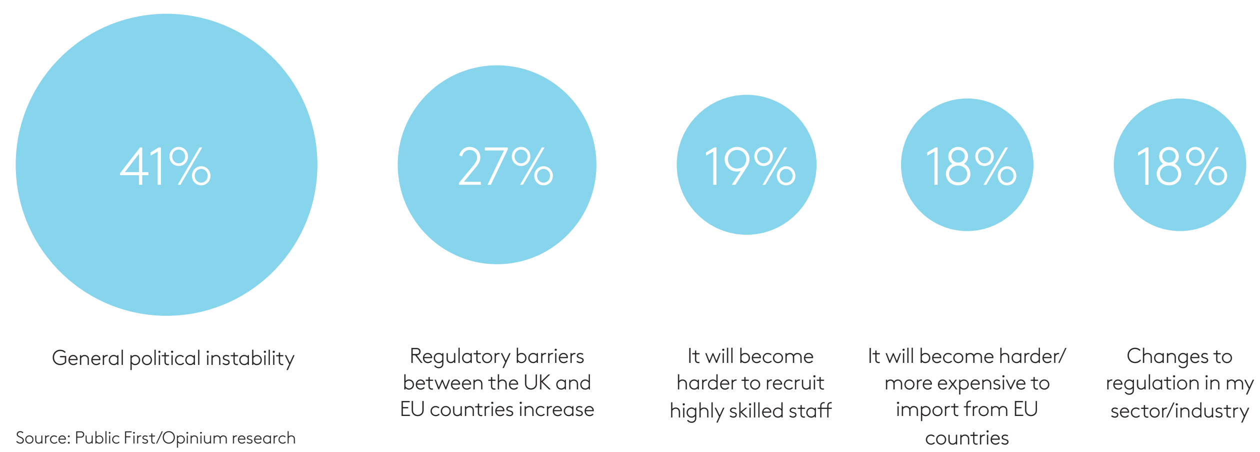
Source: Public First/Opinium research

Figure 10 The impact HGSBs think Brexit will have on their business



Source: Public First/Opinium research

Figure 11 Top five concerns HGSBs raised about Brexit



Source: Public First/Opinium research

Chapter 3: Turning UK HGSBs into global champions

To become the leading businesses of tomorrow, HGSBs need access to capital and Government support today

Octopus has invested in more than

500

early-stage companies, putting over £8.5bn into the UK economy

Turning UK HGSBs into global champions

Octopus backs entrepreneurs: we like to invest early and support businesses from one defining moment to the next

Helping HGSBs develop and grow is part of the Octopus DNA. Since we were founded in a living room in 2000, Octopus has invested in more than 500 early-stage companies, putting over £8.5 billion into the UK economy, and has grown into the diverse and successful group that we are today.

We are the largest provider of VCTs in the UK, and manage more than £2.5 billion of growth capital that is invested into companies listed on the London Stock Exchange's Alternative Investment Market (AIM).[iv] This provides vital investment that supports the expansion of small businesses, resulting in significant job creation, productivity enhancement and revenue growth. Through Octopus Ventures, we have invested more than £150 million in high-growth businesses in the past year and have backed notable companies such as Zoopla, Secret Escapes and Graze.

Listening to the priorities of the businesses we invest in is crucial – and for some, growing means expanding overseas. This led us to opening an office in New York City in 2017. Today, Octopus Ventures is headquartered in London and New York, with venture partners in San Francisco, Singapore and Shanghai – enabling us to help entrepreneurs scale globally.

Venturing stateside

Former International Trade Secretary Rt Hon Dr Liam Fox MP said that "exporting not only increases the profitability of businesses, it has a positive impact on its local economy, encouraging growth and creating jobs".[15] We agree.

Succeeding in the USA means overcoming substantial risks. The sole purpose of our New York office is to help UK portfolio companies enter the US market and navigate its complexities as smoothly as possible.

The Octopus story

2000 Starting small: Octopus Investments launches

2007 Our first acquisition is made, and Octopus Titan VCT launches

2009 We reach our first £1 billion in assets under management. We reach our second less than 18 months later

2014 Titan VCT investment Zoopla becomes the first VCT-backed business to be valued at £1 billion

2015 Octopus Property and Octopus Energy launch

2016 Octopus business units are brought together under the Octopus Group

2018 Our co-founders, Simon Rogerson and Chris Hulatt, are named EY UK Entrepreneur of the Year

2019 The Octopus Group now comprises Octopus Investments, Octopus Ventures, Octopus Renewables, Octopus Energy, Octopus Wealth and Octopus Real Estate

Octopus in numbers

£8.5bn of funds under management

500+ smaller businesses supported

45% overall growth in Octopus Ventures portfolio revenues

£89m of growth capital invested in smaller businesses in 2018

£1.2bn of investments in venture capital trusts managed, representing more than 25% of the market

70% of our portfolio have revenues outside of Europe

Ensuring that early-stage businesses remain attractive to investors is vital to the success of the UK economy

Since opening the office in 2017, we've been able to expose entrepreneurs to the people, organisations and networks that will broaden their horizons and unlock their ambitions. Direct access to resources and communication with our experts on the ground has fuelled the success of our portfolio companies.

Encouraging investment

For HGSBs to succeed, they need access to growth capital. While all businesses require investment, HGSBs benefit from long-term patient capital, which requires time to mature and deliver returns.

Ensuring that early-stage businesses remain attractive to investors is vital to the success of the UK economy. The number of businesses seeking investment far outweighs the capital available to invest, with the UK's financing ecosystem operating at capacity. This means that financial incentives are required to offset the risks involved when investing in such businesses.

The UK's successful and established financing ecosystem offers a range of incentives to encourage investment in innovative, knowledge-intensive small businesses. For HGSBs, the Enterprise Investment Scheme (EIS) and VCTs enable early-stage investment to allow them to start up and become established.

Capital pooled and invested through VCTs is uniquely placed to provide stable funding for a range of small businesses over their crucial early years. Furthermore, VCT managers often take a seat on the board of their portfolio companies, providing valuable advice and support gathered from years of investment experience in small businesses.

The success of VCTs and the EIS as investment vehicles has been underpinned by the tax incentives offered to investors. Specifically, making these investments eligible for business property relief (BPR) encourages long-term investment by enabling shares in qualifying companies to be passed on free from inheritance tax when an investor dies. This typically leads to investments being held for 10 years or more.

Difficulties scaling up

As this report explains, the UK is one of the best places in the world in which to start a business. With a strong legal system, relative political stability and the English language, the UK is a top destination for entrepreneurs.

However, the country falls behind when it comes to supporting businesses to grow: the OECD ranks the UK third in the world for the rate of business start-ups, but in only 13th position for scaling up such businesses.[16]

Critical to the success of HGSBs is the availability of long-term finance to scale up, particularly as businesses outgrow the caps on EIS and VCT investment. AIM has enjoyed huge success by allowing small businesses to access growth capital throughout the scale-up process. By releasing equity on AIM, HGSBs can raise investment at various stages, ensuring a steady supply of patient capital.

Since AIM was launched in 1995, its success has been underpinned by the ability to claim BPR on shares, which has helped to make it one of the most attractive stock markets in the world for businesses and investors.

The importance of AIM to HGSBs cannot be overstated. It is widely reported that many small

> "Exporting not only increases the profitability of businesses, it has a positive impact on its local economy, encouraging growth and creating jobs"

Rt Hon Dr Liam Fox MP
Former International Trade Secretary

> "I'm concerned about how we'll attract talent in areas like data science, maths, physics and engineering"

Case study

Elvie

CEO Tania Boler believes Brexit could exacerbate the talent shortage in the tech sector

Founded in 2013, Elvie specialises in manufacturing technology-based consumer health products for women. Its mission is to improve women's lives through smarter technology; it has developed innovative products such as a silent wearable breast pump and a smart pelvic floor exerciser.

Discussing how Brexit will affect her business, Tania Boler, founder and CEO of Elvie, says: "Like other founders, my main concern about Brexit is around the shortage of tech talent in the UK. We already face critical tech talent shortages in London.

"Some 40% of our workforce are from Europe, so I'm concerned for their welfare as we go through this period of uncertainty, as well as how we'll continue to attract great talent – particularly in areas like data science, mathematics, physics and engineering, where the UK has fallen behind some of its European counterparts."

elvie

The OECD ranks the UK

3rd

in the world for business start-ups...

...but only

13th

in the world for scaling up small businesses

businesses – often put at one in five – fail in the first year. However, the failure rate increases significantly after this and is as high as 60% after three years of business.[17]

The success of AIM businesses is felt across the UK. AIM businesses are job creators; collectively, they were responsible for a 76% increase in jobs during the past five years and now employ almost 390,000 people.[18] In its 2017 Patient Capital Review, the Government demonstrated its commitment to backing successful scale-ups. Considering the contribution HGSBs make to the UK economy and the scale-up challenge, it is important that policymakers maintain their support for AIM and encourage small business investment.

Recommendation: Continue to support investment in the Alternative Investment Market to raise capital for HGSBs

Since its launch in 1995, AIM has enabled investment of £113 billion in more than 3,850 firms, many of which are HGSBs, providing essential capital to allow them to grow and establish themselves.[19] AIM is a UK success story and has provided capital to support businesses such as Domino's Pizza Group, Hiscox and Big Yellow Group.

The success of AIM is, to a large extent, the result of targeted Government policy to incentivise patient capital investment – in particular, tax reliefs offered to private investors, which encourages investment in small businesses over the long term. The ability to claim BPR on investments on AIM and to pass these on free of inheritance tax has resulted in record levels of investment in small businesses.

The Government should make a long-term commitment to support the findings of the Patient Capital Review in 2017 and ensure that BPR is protected and AIM continues to flourish as a source of growth capital for HGSBs.

Building on AIM's success

The decision in 2013 to allow AIM shares to be held within an ISA opened up these businesses to more individuals than ever before, leading to record levels of investment. This has been hugely advantageous to HGSBs, with a wider pool of investors able to invest capital into small businesses to the benefit of investors, businesses and the economy.

However, not all HGSBs will be able to list on AIM. Building on the success of AIM ISAs as vehicles for raising growth capital, policymakers should allow shares in privately owned, unlisted companies to be held within an ISA wrapper to increase the number of small businesses able to access this investment.

Recommendation: Allow ISAs to invest in unlisted companies

The Government's decision to allow AIM shares to be held within an ISA wrapper has been incredibly successful.

Since the rules changed in 2013, Octopus has invested hundreds of millions of pounds into AIM companies with a growth mandate, comprising both new ISA investments and the transference of existing ISA portfolios that would have been invested in FTSE-listed companies or cash. ISA investments are one of the most patient forms of capital, and *we would like to see this pool of capital invested into a greater number of small businesses by allowing ISAs to invest in privately owned, unlisted companies.*

With £316 billion currently held in stocks and shares ISAs, if even a small fraction of this is invested in unlisted companies, the impact on the availability of patient capital for HGSBs would be significant.[20]

Widening the pool of investment

The Department for Work and Pensions (DWP) has stated its intention to act on the recommendations of the 2017 Patient Capital Review and allow defined contribution pension schemes to invest more in illiquid assets, such as VCTs, recognising the role they play in supporting SMEs in important sectors of the economy.[21]

Institutional funds, such as pension funds, are among the most patient forms of capital. Allowing these funds to be deployed more widely to support small businesses will help to address the shortage of growth capital available to HGSBs, as well as diversifying and improving returns for beneficiaries.

The introduction of automatic enrolment for workplace pension schemes in October 2012 has been hugely successful, resulting in a marked increase in the amount being saved for retirement. However, this large pool of capital cannot currently be invested in small businesses through VCTs because performance fees fall outside of the automatic enrolment charge cap.

The UK pensions and retirement income sector manages more than £2.4 trillion – allowing even a small proportion of this capital to be invested in VCTs would make a huge impact and would open up an important source of patient capital for HGSBs.[22]

£113bn

investment enabled by AIM since 1995

3,850

firms listed on AIM since 1995

76%

increase in jobs in AIM-listed companies in the five years to August 2019

390,000

people are employed by AIM-listed companies

Recommendation: Remove venture capital trust performance fees from the automatic enrolment charge cap

We supported the introduction in October 2012 of automatic enrolment for workplace pensions, which will see a larger pool of funds being held by pension schemes for longer than ever before. It is important, however, that this pool of patient capital is put to the best use: to provide choice, greater returns and security for the ever-growing number of pension holders, as well as unlocking investment in HGSBs.

We welcome proposals from the DWP to accommodate fund manager performance fees in the automatic enrolment charge cap. However, current limits only allow private pension schemes to invest in VCTs. Workplace pension funds are prevented from investing in VCTs because performance fees fall outside of the automatic enrolment charge cap.

Because of the proven success of VCTs in raising investment for small businesses and providing returns on investment, *we urge policymakers to exempt performance fees from the charge cap for investments in VCTs.* This will lead to greater long-term returns for pension scheme holders, and provide a stable source of growth capital for HGSBs.

Method

The analysis of the number and economic contribution of HGSBs in this report is based on the Office for National Statistics' Business Structure Database (BSD), with additional data from the Department for Business, Energy and Industrial Strategy's Business Population Estimates (BPE). The BSD is an administrative source that covers all UK businesses that are above the VAT turnover threshold and/or employ at least one person paid using PAYE. It therefore captures the vast majority of economic activity in the UK, and all HGSBs. With the BSD, we can capture an accurate measure of the number and profile of HGSBs in the UK, and how this varies in different parts of the country using the postcode at which businesses are registered. The BSD is made available for external analysis, but only in an anonymised form, which means it is not possible to link the data to individual named businesses.

The Public First/Octopus Group HGSB survey was conducted by Opinium Research between 25 June and 22 July 2019. The sample of 226 respondents comprises business leaders at or above director level in businesses with between two and 250 employees, which have grown by 70% since 2012/13 and have an annual turnover of between £1 million and £20 million.

Definitions

i This report also includes data from active businesses with an annual turnover of between £1 million and £20 million that are less than three years old but are on course to become HGSBs.

ii Gross value added (GVA) measures the economic contribution of each producer, industry or sector in the UK. It is used in national income accounts to measure productivity, or the value of goods and services produced by different economic sectors. It is calculated as the total value of goods and services produced, less the cost of all materials and other inputs used directly for that production.

iii Defined as businesses at least three years old, with an annual turnover of between £1 million and £20 million, but annual average turnover growth of below 20%.

iv A sub-market of the London Stock Exchange, the Alternative Investment Market (AIM) is the most successful growth market in the world. It allows smaller, less-established companies to float shares on a stock exchange with a more flexible regulatory environment to suit entrepreneurs.

Sources

1 The average worker in a HGSB generates £137,000 of turnover and £59,300 of GVA. This compares with £110,600 of turnover and £42,200 of GVA in LGSBs. Source: Frontier analysis of ONS data (Business Structure Database)

2 Frontier analysis of ONS data (Business Structure Database)

3 Public First/Octopus Group research

4 Public First/Octopus Group research

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We're a group of entrepreneurially minded businesses – each one built on the belief that people deserve better.

About Octopus

Founded in 2000, we're one of the UK's fastest-growing companies, operating in two sectors – financial services and energy supply.

For two decades, we've been challenging convention and turning bright ideas into game-changing businesses. We offer smart, simple solutions that leave our customers feeling taken care of, because being trusted makes us irreplaceable.

Across Octopus, we now have over 1.2 million customers and our investments have put more than £8 billion into the UK economy. We want Octopus to be a group of businesses we're proud to tell our grandchildren about.

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