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Future Fund: a user's manual

The government's answer to supporting startups throughout the pandemic is the £250M commitment to the Future Fund. Wrong. The Future Fund will be used to support scale-ups and it's important that we understand this difference.

Recent guidance providing more detail on the scheme has clearly laid out that (S)EIS will not be available to investors who are providing matched funding to companies, which effectively rules out angels, high net worth individuals and many UK family offices.

These investors are making high-risk investments into innovative businesses, with little proven track record and rely on the favourable tax breaks to alleviate some of the risks, in a model which assumes a limited number of their portfolio companies will succeed.

The Future Fund dictates that companies who raise funds under convertible loan notes can receive up to £5M of matched funding from the government. Companies will then repay these loans (at a 100% premium) or convert them into equity at the next funding round, or after three years (at a 20% minimum discount), at the choice of the investors.

The third-party investment must be made under the same terms as the government's investment, the terms of which provide very limited flexibility. There have been calls this week from founders and angels alike, for a second Future Fund which truly supports the start-up community by allowing the matched funding to be made as equity rather than convertible loan notes.

In addition to investments being incompatible with EIS, companies must be able to tick all of the eligibility boxes which will prevent many start-ups from being able to use the Future Fund.

Companies who might find themselves ineligible include:

- Startups who have been part of a US accelerator programme and therefore have a US parent;
- Companies who have boot-strapped to date;
- Businesses who have been funded by the founders with less than £250K of third party investment;
- International startups who have more than half their employees or more than half their revenue outside the UK.

> *Unfortunately, the scheme is likely to overlook many of the UK's most innovative and high-growth startups*

For those VCs who don't rely on EIS, this could be a great opportunity to invest in some high-growth businesses or to increase their holdings in their current portfolios. There is some concern that VCs will use the Future Fund to push their portfolio companies into raising under unfavourable terms, whilst reducing their own risk as a result of the government's matched funding.

Business valuations are expected to decrease within the scale-up community, and some might suggest COVID-19 was merely the catalyst in what has been an over-valued market for some time. Either way, there's no doubt that the power will shift towards the investors as growth businesses become desperate.

Is there a glimmer of hope? Convertible loan notes are not eligible for EIS relief but in theory, HMRC could amend the legislation in this regard. The government department who released the Future Fund are separate from HMRC – there is an opportunity for an EIS reform which could allow the Future Fund convertible debt to be eligible for EIS.

Is the Future Fund right for you? I would advise that businesses first look at the eligibility criteria to prevent wasting any time if your business doesn't qualify. Secondly, try to understand what convertible debt looks like on your balance sheet and what impact it will have under the various scenarios in the future.

Model scenarios where the debt is redeemed or converted at maturity or Exit in the future and at various future valuations which you hope to achieve – is this an attractive proposition?

Convertible debt instruments are not as commonly used in the UK so understanding them is critical before considering them as a funding option. Finally, you should think about whether your investors would be willing to explore this opportunity; and when I say 'your investors' I'm talking about your current investors but also the next layer of investors who you might be in early-stage conversations with.

Use your advisors to help you navigate this process. Your accountants and lawyers will be able to help you understand how the scheme works, whether you'd be eligible and model the impact on your business.

Try to be honest about whether the scheme fits for your business. Don't allow the scheme to side-track you from concentrating on your business continuity plans. For many startups, the government schemes announced to date will have provided little solace and it's natural to feel disheartened by the lack of support.

> *Now is the time to do what you do best, stay agile, explore different business models and remain optimistic*

Remember, WhatsApp, Uber, Instagram and many more successful businesses started during or soon after the 2008 recession. Perhaps the government will benefit by taking minority equity stakes in many of today's scale-up businesses, although in my view they've missed a trick by ignoring the startups.

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