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The state of the UK economy: What do startups need to know?

How is Rishi Sunak's plan for a rival Silicon Valley in the UK going? We dive into the realities of the UK economy and what this means for startups and founders.

After a prolonged false start, Rishi Sunak finally ascended to Number 10 in November 2022 to take up the prime ministership of the UK. Facing an economy in turmoil, many anticipated Sunak would calm the waters and steer the post-Brexit Britain ship back on course.

Central to his brand, not just through his campaign for Conservative leader but in his years as Chancellor, has been his pledge to turn the UK into a "science and technology superpower", a rival to Silicon Valley fuelled by the nation's best universities, entrepreneurs, and investors.

But in the years that Rishi coveted the top spot in government, is this how he imagined it panning out? The UK economy is in an extremely fragile state, battered by the punishing winds of Brexit, COVID, and the first European war in decades. Across almost the entirety of the public sector, workers are striking, demanding higher pay and improved working conditions. In some weeks, it felt like the whole of UK public services was grinding to a halt.

For business leaders, especially early stage founders, uncertain waters lie ahead. Here, we'll look into the reality of the state of the UK economy, as well as what this really means for startups: from a hiring landscape full of opportunity, to a competitive but potentially fruitful fundraising market.

The ugly truth

Let's start with the numbers—the hardest pill to swallow with regards to the current state of the UK economy. No matter which way you spin it, things are looking gloomy.

The UK is on the brink of a deep recession, which could now be *twice as bad* as previously thought: GDP is predicted to drop 0.7% over the course of 2023. As a wider picture, the UK witnessed the *worst growth* across all of the G7 countries. That said, while it may cut deeper than previously predicted, it will likely be shorter than expected, with growth returning in the summer.

Inflation has dipped since the record highs of 10%+ towards the end of last year, but still remains sizable, recorded at 9.2% in December. This has sent shockwaves across the economy. Real wage growth (adjusted for inflation) has fallen around 2.6% over the last year, the biggest drop since records began in 2001.

Simultaneously, interest rates remain at an all-time high, with the *Bank of England expected* to increase it again in February by 0.5% up to 4%. As a result, *PwC predicts* house prices will fall by around 8% over 2023, the second sharpest decline for 70 years.

Employment rates have increased slightly over the last year, with 32.8 million people in employment: although this remains some 200,000 below pre-pandemic levels. What is striking is the increase in redundancies: 97,000 people lost their jobs in Q4 2022, 30,000 more than in the previous quarter.

The Brexit backwash

Three years since the official Brexit deal went through and the UK is still feeling the backwash of its biggest and most controversial political decision in decades. Its direct effects may be harder to trace, but the outcomes are clear. The UK is the only G7 economy that remains smaller than it was pre-pandemic, while the Pound has lost a fifth of its value since the 2016 Referendum.

Trade has been the hardest hit. In 2012, prime minister David Cameron pledged the UK would hit a £1 trillion export target by 2020: now, that lofty target is *believed* to be closer to 2035. *77% of businesses* said that Brexit has not helped them improve sales or grow their business, according to a survey by the British Chamber of Commerce.

Startups will feel the impact of Brexit in many other ways. Hiring, for instance, remains a challenge, as it becomes harder to bring over top talent from Europe due to visa restrictions. Funding too: while Brexit may not have had as big an impact on VC investment as previously thought, it remains a huge obstacle to many funding pots that the EU offers. The UK grant ecosystem is not able to compensate for this lost opportunity.

What is the government doing about this for startups?

The question for Rishi Sunak is: what does he need to do now to realise his dream of a UK Silicon Valley? There is no doubt a huge challenge ahead.

The Autumn 'Mini' Budget Statement gave some indicators of this government's attitude to startups, entrepreneurship, and innovation. First and foremost was the announcement of the Long-term Investment for Technology and Startups (LIFTS) competition, a £500M scheme to support new venture capital funds and charge investment in startups.

We saw significant changes to tax credit schemes. On the down side, the Budget slashed R&D tax credits for SMEs—roughly equivalent to a 30% reduction in tax benefits for small businesses. This was combined with an increase in corporation tax.

On the brighter side, the RDEC tax relief scheme will increase from 13% to 20%, rewarding companies investing in innovative research and development. We also saw significant changes to the SEIS rules, the tax incentive scheme that gives individual investors up to 50% of their investment back as a credit against their income tax liabilities. The lifetime SEIS allowance that companies can claim for increased from £150K to £250K (as well as extending the time period from 2 to 3 years), while investors can now invest up to £200K using SEIS annually, double the initial £100k. All this is a huge indicator that Sunak is looking to incentivise individual investment as a way to get more early stage businesses off the ground.

His prior activity as Chancellor suggests there's more to come from Rishi. The Future Fund, launched in May 2020, saw the UK government co-invest around £1.14B with VCs into businesses affected by COVID. That said, the upcoming Spring Budget, announced on March 15th, will force some tough decisions. A sharp drop in UK growth means that the impending budget will give Chancellor Jeremy Hunt around *£9B less* to play with, not withstanding pressure from his own party to cut taxes. With other, much more pressing priorities, Rishi's startup agenda may have to wait.

Macro considerations for UK founders

The talent market in the tech industry is certainly experiencing a turbulent period. Employment rates may have slightly increased overall, the last few months has seen widespread layoffs at many of the largest tech companies.

Facebook announced 11,000 job cuts (around an eighth of their workforce) in November, with as many as 650 in the UK. Alphabet are laying off 12,000 workers: although UK numbers aren't clear, proportionately this would amount to around 300 people. Many scaleups and recently crowned unicorns are cutting back too: Cazoo, Babylon Health, and Hopin are just some of the recent UK successes that are laying off employees. Arrival, the EV manufacturing, announced in October that they would largely be focusing on the US market, leaving UK jobs up in the air.

"The talent market is being distracted by redundancies at Big Tech firms. The cuts have brought those companies back to their 2021 headcount at the most. Their previous post pandemic growth was never tenable. This recalibration has acted as a contagion and infected the confidence of VC," explains Akbar Karenga, talent expert and founder of UK talent consultancy Maarusi.

For startups who are in a position to hire, there is a huge opportunity here to tap into a talent pool of increasingly high quality. Those who once sought after top jobs at Big Tech firms will now be adjusting their risk appetite and may be more inclined towards jobs at earlier stage startups. The promise of top salaries and secure jobs at Big Tech companies is significantly diminished, and startups can offer something much different in value: a sharp learning curve, the chance to shape the strategy of a company in its infancy.

Fundraising presents a bigger challenge. Venture capital largely dried up in H2 2022, and startup valuations were driven down, forcing founders into a real dilemma: accept venture money at far lower valuations and excessively dilute your equity, or delay fundraising and risk burning through your runway. Many founders opted for the latter.

This signals two things for 2023. One, there is a lot of 'dry powder' (already raised VC money) waiting to be deployed this year; secondly, far more companies will be going out to raise. In sum: more capital, but much more competition.

Earlier stage startups have a slight advantage here, however. For one, many growth investors (who might invest at a later stage, e.g. series C onwards) are now looking to invest at an earlier stage (seed to series A). This is because it allows them to deploy much smaller pockets of capital to keep their firms ticking over. These startups also have a much slower burn rate than large scaleups: if they can weather the storm, they may emerge the other side as a dominant competitor.

The overall picture is certainly far from where the UK startup ecosystem may have seen itself five years ago. If he is the advocate for innovation he says he is, Rishi Sunak will use his likely limited tenure to boost startups and their founders. But one thing’s for sure: he’s got his work cut out for him.

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