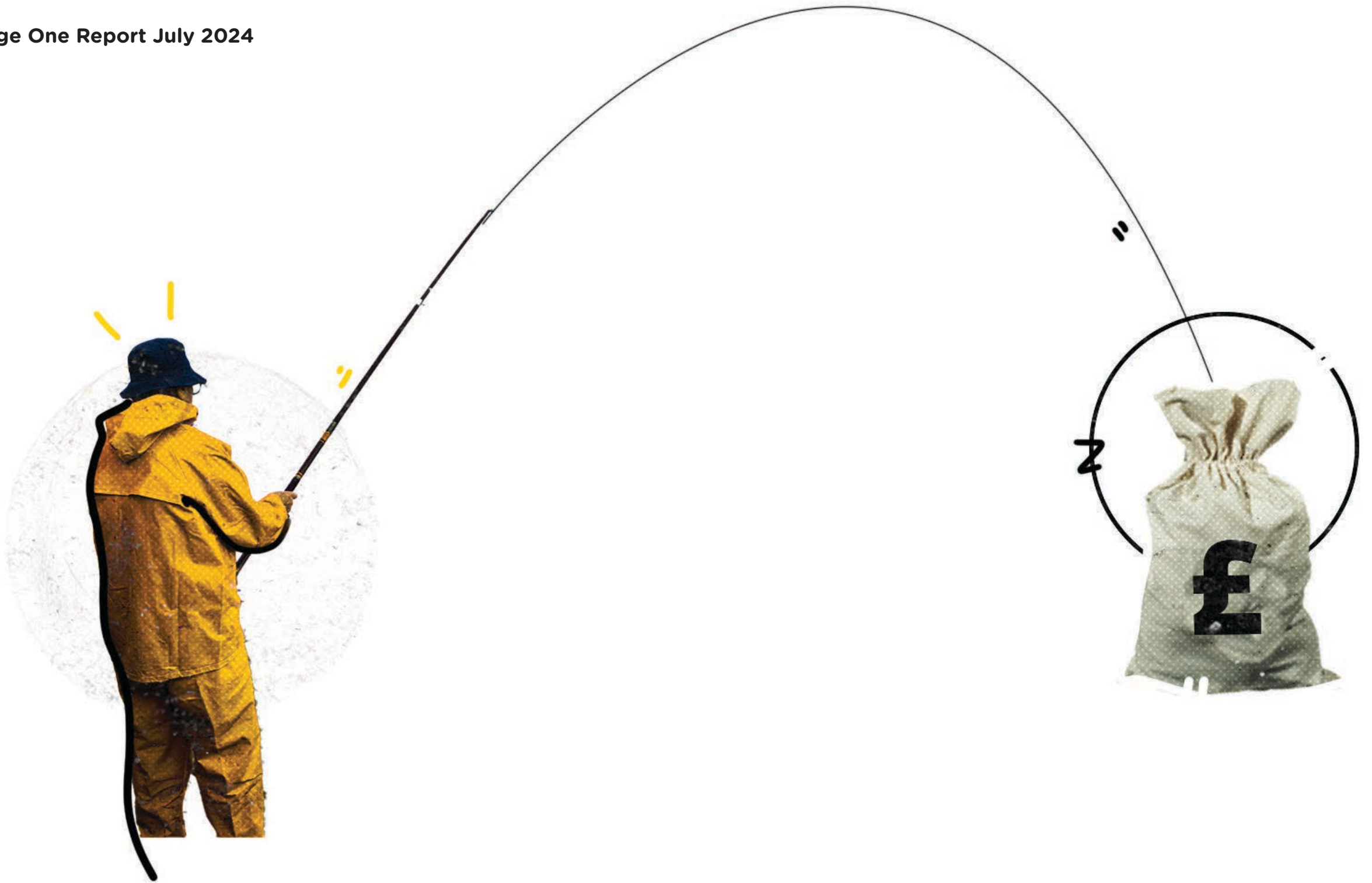


HOPEFUL FINANCE

Stage One Report July 2024



OVERVIEW

Upstarter works with people who are not your usual startup founders, and who are currently underserved by the mainstream startup services. Upstarter provides bespoke programmes and business support. Our work is to help them start, thrive and (if they want to) scale. The creative companies and social businesses we work with need a radical kind of entrepreneurship support that is founded on principles: inclusion, sustainability, and business for good. The current investment system consistently fails to invest in creative and social businesses with great potential.

But let's put this into context. Creative industries produce a GVA of £102 bn in 2021, which is greater than aerospace, automotive, life sciences, and oil and gas sectors combined. If we have £102 bn in GVA now — imagine the economic contribution from the 95% of creative and social businesses who want to grow organically and the 5% who want to fly if we actually supported them with the right interventions at the right time. Given this potential of creative industries this looks like a lot of wasted opportunities. We wanted to understand what's broken and what's possible.

Why Hopeful? Because we need a better way of financing innovative new ideas by people with lived experience that means they are closer to the issues that the innovation is based on. We need finance that is more equitable and accessible.

Context: The problem as we see it

During the course of Upstarter's work with creative and social businesses, we have observed a structural problem with investment into the businesses we support - the fuel that these businesses need to bring a new product or service to market, or to grow into a new stage. The investment system seems to work against them, just at the point where they need it to work for them the most.

There is an assumption by most programme providers that the Silicon Valley model of

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new products into startups financed by equity investment should be applied to creative businesses and social enterprises. We witness this in all forms of incubators, social and creative business programmes, where gaining investment is a key performance indicator of programme success.

In our experience over the past ten years of working with these kind of businesses we have found that there is a series of factors at play in this system, and they occur in both sides of the business/investor relationship:

- Creative businesses and many social enterprises don't appear appealing enough to equity and even to some impact investors, because they won't be making tech startup-like 10x returns quickly enough, and have a completely different trajectory
- Investors do not understand how a creative business works and therefore assume that they are a higher risk
- While both are motivated by success, they have very different ideas of what defines success
- Competition for public sector funding is increasing. The qualifying hoops include finding match funding from an investor, or time consuming applications, and reporting
- Alternatives are being explored but they are not yet available to all

On the one hand, most investors, especially equity investors, consider creative businesses to be riskier than technology-led businesses. They may not understand the creative business and how it operates. They may expect exponential returns, which most creative businesses are unlikely to deliver. They are set up to sell the company on exit, which many creative founders, after crafting a solid business don't wish to do.

This results in an inflexibility or inability on the part of the investor to see the opportunity ahead of them.

On the other hand, creative businesses are often led by founders who are not as deeply skilled in business as they are in their primary discipline. Investors perceive this as being 'bad' at business. Making money may be important to the founders, but it is the secondary motivating factor. They often do not have friends and family with deep

pockets to invest in their early ideas, in the way that technology founders often do. Many investment funds do not fit them. Many public grants are not for their kind of purpose (though that is changing), and are increasingly competitive. Similarly social enterprises face a huge learning gap, in needing to create cash flow when all they are focused on is serving a social need. They have to reshape themselves to be right for an impact investor.

This results in creative and social business founders being unprepared to negotiate confidently with investors, unfamiliar with their world and expectations, and understandably fearful of what it might mean to get into bed with one.

Completely viable businesses are missing out on critical funding at a point when they need it. This slows the progress of the business, taking significantly longer to get to the next stage where they could be making revenues. New businesses with compelling ideas that could create significant impact or those that are built around slower pace of revenue growth simply do not progress. The result is that their businesses either run out of time or money, and the founders burn out in the process.

This is a lot to ask of people, that they should stake everything on their own. We cannot support a system that only looks for rapid growth — 'unicorns' as our startup colleagues call them. Organisations like Zebras Unite challenge this thinking, working more with wonky-shaped businesses that build sustainable companies that will exist in the future. As Esmé Verity says: "Unicorns might be what investors wish for, but they are not real".

Our intention

A few years ago Upstarter set out to discover if there is a way out of this dilemma, and were told no. We took that as a challenge and set up a longer-term project to discover how it might be possible.

We want to find a new path. We will look for new investment vehicles that better fit creative and social business dynamics and their shape and intention. We set out to find out what might be possible, and how it might happen.

OUR PROCESS

To begin to explore new possibilities we designed a process, a series of activities and research. This report is based on us completing the first stage.

1. Talk to people, understand the system.

- we instigated workshops with companies and academics, surveys, conversations with companies and interviews with people engaged in different parts of the investment system to gain a variety of perspectives
Understand the system - what is the system, who is winning and who is losing?
Look for the light
- identify the leverage points in the system where change can happen

2. Make some propositions - prototyping a set of propositions for potential vehicles, mechanisms, forms and products that might work. Test the propositions - design and make testable versions of the propositions to determine appeal, blockages and to create evidence of which are desirable and feasible with investors and companies

3. Get them made Get the viable ideas set up as legal mechanisms, and explore their route to market as products.

“Every system is perfectly designed to get the result that it does.”
W. Edwards Demming



Our findings: How things are

Despite advice from a previous study we commissioned that insisted 'this is just the way things work', and that it is 'down to creative and social businesses to demonstrate how appealing they can be for investors', we were simply not convinced. After all, if every system has been designed, can't we design new systems? Business guru W. Edwards Demming thought so when he declared:

"Every system is perfectly designed to get the result that it does."

We found that the financing system works well only for a specific group of people, that there are new kinds of funds and that there are glimpses of new ways of thinking and new ways of doing things.

Increasingly we have heard the use of the metaphor of foie gras - the goose rapidly fattened for a quick sale - when talking about the expectations within the technology startup world of a new business to make ten times the money invested in them as return on investment. We are frequently seeing the fault lines and limitations in what was believed to be a perfect system.

Barriers to finance

Access to finance is a critical challenge for almost every creative and social business we have worked with. What comes up as a consistent request is the need for money to make things happen, or to grow:

"the most important thing, structurally, is the availability of money — and while the biggest constraint on creativity on people is access to opportunity, to training, to contacts, and so on — everything, everything, everything relates to money, in every part of the system, and that's the

greatest barrier and the greatest enabler." Sameer Padania

Yet in the UK we find that money — talking about, asking for, and not having money — can be a huge emotional barrier for people. Padania believes this to be even more systemic, in that, in the UK, not only is talking about money often taboo, but also that applying for funding can put the grantseeker in the position of a supplicant:

"I think in our culture, there is already a weird reluctance to talk about money anyway. But then when you're going to ask for money, there isn't really the forthrightness that you find in the US. It's not a supplicant relationship there, it's a very, very direct function." Sameer Padania

In this way, those who have the confidence in the system in asking for what they need are being listened to.

Nothing has changed for the underserved (or who gets to grow their business)

Creative businesses experience difficulty in attracting investment, yet are not the only under invested groups. It is much harder for women and minoritised founders, or those who do not understand this world and how it operates, to access finance.

According to Forbes, if you are a women leading a business your access to investment is 3.5% in 2023 and for all men it is 85.1%. The story is different for people of colour: 11% of funding rounds went to people of colour, and it is worse for Black women-led businesses, the fastest growing group of entrepreneurs, who only get to raise 0.14% of VC investment. Access to VC equity funding on the whole declined sharply in 2022, and continued in 2023. Despite declarations to invest more in these groups, nothing of note has changed. Black investors are finding that they simply need to set up their own funds to support them. Kevin Withane, founder of investment

company Diversity X, is one of these pioneers:

"When I started looking at the reports that come out year after year, on the lack of funding for people of colour, I realised the pace of change is too slow. I actually started doing a bit of research and went back 15 years. There's no change. It's all well and good doing a report talking about we're gonna make these changes, but actually what's happened? Nothing. Nothing." Kevin Withane

"Women have less access to capital, generally, if they are sole founders or a team of women, [than if they are or have male co-founders], and the data [on startups for example] tells us that when they do get funding, they tend to get less of it. Minoritised communities are in a similar position." Sameer Padania

Minoritised founders find the language, operating rules, and code of a very different world the main reasons why they are put off even approaching investors, who in turn do not get to know anyone outside of their usual circle:

"...that's a serious problem, because what this also does is make people who are marginalised from those spaces feel like they don't understand the code. And you don't know if you're saying something wrong. That's a structural issue that is very, very problematic. And that is a barrier to people even considering going for money to different kinds of sources like that, because they're just like, wow, I wouldn't know how to do that, or I'd make a fool of myself." Sameer Padania

Some kind of on-ramp for founders, to become familiar with investors earlier and have a guide navigate this world certainly helps. We have run no-pitch events to bring companies and investors in the room together earlier, but it takes a lot more to connect these different worlds.

The system is really a casino
Melanie Rieback describes the traditional Silicon Valley equity-based investment system as very much like a casino. She shared with us how the

“85% of VCs don't make money for their LPs.”
Melanie Rieback

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equity system doesn't even work for all of the actors. In effect it only serves those who are in specific roles, and the returns for the remainder of actors are undermined by compound fees and interest. We asked her who wins out of this situation:

"85% of VCs don't make money for their LPs." And when asked how this breaks down, she explained that:

"Service providers (like fund managers and financial lawyers) get paid fees regardless of the performance of investments. Fund managers typically have a 2% Asset Under Management fee, and such fees compound. This eats away at returns for pensioners and retail investors like us. There is an entire ecosystem of fund managers and service providers, getting paid a fixed fee, regardless of performance, they always win."

The main reason that the equity investment environment is such a challenge for creative and social businesses is because of the pressure for high returns of 10x within a very short timeframe, which is particularly hard for companies that cannot scale through technology. But it could be possible for investors to adapt expectations:

"We need to be moving money into different funding vehicles. Traditional investment seeks to maximise financial return, but we need private wealth holders and big holders of capital to be more open minded and fund different financing vehicles that come with different return expectations. Founders then need help figuring out what they can offer investors, which will narrow down the pool of investors they can target and make them easier to find. All it takes is the ecosystem to work together." Esme Verity

Working together is precisely what we want to contribute to. So can there be cause for hope when we have so many barriers to finance and are unable to ask for it?

OUR METHODS

Interviews:
Esme Verity, Considered Capital
Melanie Rieback, Post Growth Entrepreneurship
Sameer Padania, Macroscope
Kevin Withane Angel Investor, Diversity X
Martin Rigby, VC ET Capital

We asked them for their multiple perspectives on this complex system:

- How does the existing investment system work?
- Who wins in the current system?
- Who loses?
- Where are the leverage points?

Workshop:
Imagining new Financial Models for creative technologists with academics and guests at the CTC New Futures for Creative Economies conference
29th/30th March 2023
Watershed, Bristol.
<https://ckc-conf.co.uk/2023/schedule/>

Surveys:
Data from multiple programmes asking about investor awareness, relationships, likelihood for approaching investors, and amounts required and raised.

Conversations:
with creative and social businesses through B+B Creative R&D, SWCTN, BSWN's Social Entrepreneur Incubator, Clwstwr's Programme, WECA Create Growth, Creative Scale Up and Creative Sector Growth Programmes.



WHERE THERE

Hopeful Finance

There are recurring patterns in the responses from our interviewees, which chime deeply with what Upstarter is aiming to achieve. One aim is to find a better way of connecting, not just via aggressively pitching, but on a more emotional level, and a second way is to build the new vehicles, institutions and formats that we need for the future to nurture creative and social enterprises.

Seek affinity and solidarity

Our research and interviews gave a sense that different ways of connecting companies and ideas to investors can be possible outside of the traditional methods — big pitch events where ideas get torn apart by intimidating investors. There are contexts in which this method does not work, and also, there is a growing appetite from investors around connecting with issues that matter to them, instead they get to have an impact, support those making the impact and the 10x returns are not the point. Hybrid funds are the opportunity, and investors can decide on affinity.

The VC we spoke to told us that he has seen a change in the past ten years in how creative companies have moved closer to understanding how equity investors think. He believes that finding alignment and affinity is key:

“I think that for the creative industry you’ve got to concentrate more [I think is where I’m coming from] on the idea of affinity. The leverage is to find investors who want the affinity of values or purpose or just simply to invest because whatever it is you do is something that echoes in their soul.”
Martin Rigby

Spending more time in their neighbourhood during the Covid 19 pandemic changed how people consider local resources such as local media and movements around solidarity for actively investing in services people want to exist in the future.

“You’ve got to realise that these forces, like Covid, suddenly forced people to stay in the places where they live, and realise ‘hang on, I don’t know what’s going on my own community’. It made many people become more aware of the businesses and organisations that are providing news and information about and to their local area - and made them think, ‘Okay, I need it. But how is this being paid for? Is there a model, some sort of part subsidy or part subscription or solidarity model, that enables these local information providers to at least have some of their costs underwritten? And then they can stand on their own feet, and try to be socially oriented businesses. So I think that - to me - is changing. And I think you can see on a local level, there’s a new appetite for that.”
Sameer Padania

Building what we need Make our own funds & mechanisms

Kevin Withane decided to do something about the realisation that things have not changed for minoritised founders, by setting up his own organisation that could support them and ensure post programme support:

“I will only ever invest in underestimated founders: women founders, people of colour, LGBTQ plus disabled, neurodiverse. And I would like to also say, first time older founders, aged over 50 because they are overlooked as well. I don’t invest in mixed teams where the underestimated founder does not have an equal footing in equity. Right. Equity. You’ve got three founders. Well, it needs to be a third each then.”

Sometimes you have to make what you need, in order to make change happen. And there is a growing hunger to make what we need, much in the spirit of the work by Diversity X. Kevin went further to build a community of support around underserved founders, that is working:

“Private wealth holders and angel investors are where the big opportunity lies. if you’re a high net worth individual with considerable wealth, do you need to be accumulating more money? Or could you actually use your money in a more philanthropic manner and accept a lower financial return? You could be using your wealth to fund more social businesses that generate significant impact. “ Esme Verity

“The Diversity X community is supportive because they’re all in the same boat. They’re doing different things, but they’re all guiding each other based on their own experiences. So they’ve all had the struggles and they’re still struggling. The one thing I do see is absolute resilience. I know many of them are working on problems they have they’ve experienced either firsthand or have a good knowledge of that issue. I think it makes a real difference.” Kevin Withane

What is essential is to make new examples of the kinds of business, financial mechanisms and investment vehicles that fit a non-extractive approach and align more closely with social and creative enterprise.

“We need airtight ways to structure financially non-extractive businesses (and investment funds). And we must discover how by experimentation: trying things, making mistakes, seeing how people cheat, and then fixing the loopholes. There’s no off-the-shelf, non-extractive business entity forms available to us yet, so we have to DIY it with contract law.”
Melanie Rieback

Angels are the opportunity for many of the kinds of businesses that Upstarter works with, because they have more autonomy about how they use the money, and how they can form funding groups or syndicates.

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The ability of investment to create more wealth can be further explored - and not all investors only want financial returns; there are signs of change in what wealth creators want:

“...you’ve got people who are starting to look at wealth creation and think not in an extractive way - they still want to create wealth, but they want to see how that wealth can stay, circulate and grow in this place, in this locality.” Sameer Padania

Staying in the location, investment circulates and builds new wealth, as explored by the New Economics Foundation in Plugging the Leaks (see reading).

Change the form of agreements

“The first leverage point is financial incentives. We need to make business and finance non-extractive. We need to lock the financial value into businesses and funds: this would require non-profit entity forms, golden shares, and strong asset locks.”
Melanie Rieback

Designing hybrid and new instruments

“... I don’t necessarily think it’s about changing the VC model. The goal should be creating more funds that use a wider variety of instruments with different return expectations.” Esme Verity

By deliberately bringing a veteran VC into the conversation, we expected to discover a harder attitude to designing new mechanisms, but found someone ready to examine the idea of hybrid instruments that could work harder, or differently:

“The whole industry now only ever really thinks about equity ownership. There’s very little thought given to hybrid instruments where you have been running yield and income, which creative businesses are often better at generating, rather than long-term capital value.” Martin Rigby

Given the opportunity to consider what else might be created to help fit these businesses better, Martin Rigby builds on the idea that we could create new mechanisms, and starts with one:

“So your point, which is absolutely right, is that surely we can conceive of a mechanism where businesses can raise long-term debentures, which carry a coupon, which are not like short-term loans, so you’re not leveraging business and creating a stressed balance sheet. The investment could alternatively be in preference shares which have particular characteristics which suit that kind of business but also suit a certain kind of investor.”
Martin Rigby

IS HOPE

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“Creative industries produce a GVA of £102bn in 2021, which is greater than aerospace, automotive, life sciences, and oil and gas sectors combined. If we have £102 bn in GVA now — imagine the economic contribution from the 95% of creative and social businesses who want to grow organically and the 5% who want to fly if we actually supported them with the right interventions at the right time.”



HOPEFUL FINANCE FUNDING MODEL

In our experience the classic technology or business journey does not apply and is not a true reflection of creative business and social ventures, who are at their heart specifically different in how they are motivated, how they operate, and how they wish to end.

The lack of easy to access early stage capital means that businesses flounder or stop. Getting to any kind of viability comes at a high costs to the founders and is all but impossible. Our premise is that we could rethink the funding model, to better fit them.

FOUR DIRECTIONS

[FUND SOURCES] + [STAGE IN BUSINESS JOURNEY] + [TIME PERIOD] + [AMOUNT INVESTED] + [RETURN EXPECTATIONS] + [METHOD OF EXTRACTING THE INVESTMENT]

Where next: designing hope. The following are topline descriptions of our four directions of investment vehicles. Each will have a means to make the fund, the terms on which it can be used, ticket size (amount), kinds of shares and payback period. Each requires user testing and further development as prospective legal and FCA approved methods.

Overall we would like to create a range of phased funding opportunities for different stages, through various combinations of funds and investment vehicles with specific roles across the business stages. Here are four new, and not so new, investment vehicles drawn out of our research, workshops and conversations.

1 A Robin Hood approach
 What if we were to establish a funding pot made from additional levies on money applied for in research grants, funds and projects in a particular location? When applying for a grant, the applicant could add a 10% levy for a local fund that can be governed and distributed by local people.

2 Community Solidarity Funds
 What if we were to establish a local investment fund from local businesses and organisations, focussed on local priorities? This model works for community-based resources that people want to invest in, such as local media and local youth services.

3 Fiscal Fundraising model
 What if we adopted a Fiscal Fundraising model, where 90% of post taxable profits are put into a fund? We would enlist creative, social and other companies to sign up to putting this amount in a pot together for issue-based or suitable companies needing startup, development or growth finance.

4 Affinity Fund: What if we start with what matters: to package prospective companies on the basis of their impact motivations, in order to be able to matchmake them with angels who care about the specific impacts?

OVER TO YOU



Our first ask is for six organisations or individuals to invest the next stage of our work. Two organisations have already agreed to invest £10k each.

Each £10k will enable us to reach our target of £60k where we can put some clear testing time into action, bring in people and experts to help make these propositions clear and understandable to both sides. Once we have these findings, we will have a clear steer on what both sides consider worthy of developing further, and evidence of interest. We will also know what to abandon or adapt, and how.

Our second ask is for £20k from five or more organisations, to help pay for the legal and financial instruction and set up processes.

If you would like to respond to these asks or for more information please contact us at hopefulfinance@upstarterincubator.com

WE NEED YOUR HELP. This document only details the findings of the first stage in our process. There are two further stages of development:

Our next stage is to test a set of propositions from investors and candidate companies, and explore with them whether they are appealing, or at all possible.

Following that we will rework the propositions that are considered desirable and viable, and to do the necessary legal, governance and FCA work to set them up.

Inspiration

We are inspired by all of the bodies exploring new ways of releasing and sharing wealth, including:

Zebbras Unite: A founder-led, cooperatively owned movement creating the culture, capital & community for the next economy
<https://zebrasunite>

<https://www.inclusive-capital.us/>

Emma Shaw, Library of Things and Fair X

The Good Ancestors Movement <https://www.goodancestormovement.com/resources>

Reading

<https://www.forbes.com/sites/philipsalter/2023/11/06/just-35-of-equity-investment-for-the-first-half-of-2023-went-to-female-led-businesses/>

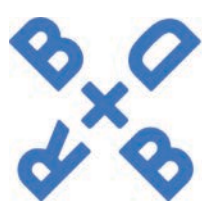
Innovation Blind Spot, Ross Baird

<https://neweconomics.org/uploads/files/plugging-the-leaks.pdf>

Racial Diversity in Private Capital Fundraising
Johan Cassel, Josh Lerner, and Emmanuel Yimfor
August 5, 2023

Thank you to all of our interviewees: Sameer Padania from Macroscope, Esme Verity from Considered Capital, Martin Rigby from ET Capital, Cambridge, Kevin Withane from Diversity X and Melanie Rieback from Radically Open Security and Post Growth Entrepreneurship.

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