BVCA Response to the Business, Energy and Industrial Strategy Committee Inquiry - From Start-up to Scale-up: Support for Growing Businesses

1. The British Private Equity and Venture Capital Association (BVCA) is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 600 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers and investors.

2. The fundraising environment for start-ups has improved significantly over the last five years. However, many entrepreneurs whose businesses have moved beyond the start-up phase, have demonstrated the commercial viability of their business, and are ready to scale up, find it difficult to raise later stage funding. The shift in perspective on the part of policy makers from start-ups to scale-ups is therefore welcome.

3. This response outlines a number of barriers to the UK venture capital and private equity industry's ability to invest in the larger, later-stage funding rounds associated with scale-ups, and proposes some measures that can be adopted by the Government and the industry to overcome them. Further detail on the benefits of a thriving private equity and venture capital industry, and its role in the scale-up ecosystem, can be found in the BVCA's response to the Government's green paper on industrial strategy.[1]

Increasing the size of the UK's venture capital industry

4. Increasing the number of larger venture capital funds in the UK will improve the industry's ability to both support companies over the long-term and to make investments at the crucial scale-up stage. Larger fund sizes permit larger and more frequent follow-on funding rounds, enabling fund managers to stay invested in a business through multiple rounds, including the later scale-up phase after a company's business plan has been tested and proven. For smaller funds, investing large amounts in in a single company makes it more difficult for the fund's portfolio of investments to be sufficiently diversified to mitigate losses to investors should any single investee company fail.

5. Recent comparative studies of the US and UK venture capital markets have evidenced the link between fund size and longer-term investment. A 2016 report published by the Scale Up Institute and Barclays found that median UK fund size was $78m compared to $100m in the US, which fed through into the size and frequency of follow on funding rounds.[2] Only 15% of UK companies' investors invested for 3 rounds or more compared with 25% of US companies' investors. Research by the British Business Bank corroborates this finding, showing that only 9% of UK companies with series A funding received series D funding, compared to 23% of US companies (and the disparity widens further down the funding chain in later rounds).[3]

6. Average amounts invested in later rounds were also smaller in the UK when compared to the US. On average, UK companies raised 15% less in Series D rounds and 23% less in Series E than their US counterparts. This is important as companies seeking to grow rapidly not only need investors to be able to make follow on investments after their initial investment, but also require higher levels of funding in aggregate to meet their growth potential. The disparity

[1] BVCA response to the green paper on industrial strategy – available here
[2] Scale-up UK: Growing Business, Growing our Economy report – available here
[3] British Business Bank, Small Business Finance Markets report – available here (page 56)

between later funding round sizes in US and UK is likely to reflect the fact that the median size of funds that stay invested beyond the second round in the US is 41% bigger than the comparable figure for UK funds.[4]

7. The key challenge for the Government, therefore, is to support the UK's venture capital market to develop sufficient scale to stay invested through multiple funding rounds, particularly through to the later rounds associated with scaling up a business.

Attracting institutional investment into UK venture capital

8. Driving more institutional investment into UK venture and growth capital would ensure that the industry reaches sufficient scale to invest large amounts into companies over multiple funding rounds, thereby helping UK SMEs scale up into larger businesses. However, our members frequently comment on the difficulty of attracting institutional investment into UK and European venture capital funds, particularly when compared to the US. There is no single reason why UK and international institutional investors are reluctant to invest in UK venture capital, but the following factors are likely to be significant and have been raised through discussions with our members.

9. **Perceptions of returns** – Historically UK and European venture capital returns have been poor, largely owing to the effects of the dot-com bubble. However, 2002 vintage venture capital funds onwards have performed better, outperforming both the FTSE all share index and UK pension funds. The issue around returns, therefore, is one of perception rather than performance as set out in the table below[5]. However, another challenge is that returns from private equity funds have generally been higher which may have led to more institutional money being allocated to those funds rather than venture capital.

BVCA Performance Measurement Survey, 2015

	2015 (% p.a.)	**3 years (% p.a.)**	**5 years (% p.a.)**	**10 years (% p.a.)**
VC – pre-2002 vintage funds	0.4	19.5	4.3	-0.3
VC – 2002 vintage funds onwards	10.9	15.5	10.4	7.9
Total Pension Fund Assets	2.9	8.5	7.5	6.2
FTSE All-Share	1	7.3	6	5.6

10. **Ticket size** – Large institutional investors have significant sums of money to deploy. However, because of the large number of relatively small UK funds, ticket sizes (i.e. the minimum amount of investment required to enter a fund) are typically smaller than the minimum level at which it is viable for larger institutional investors to commit.

11. A study commissioned by the European Commission suggests that the minimum amount large institutional investors will typically commit is between €25m and €50m (rising to €100m for sovereign wealth funds).[6] Furthermore, according to the study, institutional investors will typically invest no more than 10% of a fund. This suggests that, as a bare minimum, funds need

[4] Scale-up UK: Growing Business, Growing our Economy report – available here
[5] BVCA's 2015 Performance Measurement Survey – available here
[6] European Commission Horizon 2020 report – available here

to aim to raise at least €250m (£220m) before they can attract substantial amounts of institutional investment.

12. Overcoming the barrier created by the smaller ticket sizes will be particularly difficult given that ticket size is itself a function of fund size—smaller venture capital funds need more institutional investment to reach scale, but large institutional investors are reluctant to invest in smaller funds. It is likely that government support will be required, at least in the first instance, to address this market failure.

13. **Fragmentation of public sector pension funds** – In North America, public sector pension funds and university endowments are important investors in venture capital. In the UK there is too much fragmentation among public sector schemes. This means that most public schemes in the UK do not have sufficient scale to make a difference on a national level, and many smaller schemes do not have the expertise to make large commitments to alternative asset classes.

14. This problem, however, needs to be addressed in parallel to the issues noted above in respect of ticket sizes. Larger pension funds will typically have larger minimum ticket sizes, and, as discussed above, this already makes attracting institutional investment for venture capital difficult.

15. **Regulatory Barriers** – The Government should examine whether there are any regulatory barriers preventing institutional investors increasing their allocations to venture capital.

BVCA data on fundraising in the UK - by investor type

	2013		2014		2015	
	£m	%	£m	%	£m	%
- UK	137	1%	305	3%	687	6%
- Other EEA countries	332	3%	673	6%	372	3%
- US	1,635	15%	1,372	13%	489	4%
- Rest of the world	839	7%	327	3%	360	3%
Pension funds total	**2,943**	**26%**	**2,677**	**25%**	**1,909**	**16%**
Total from all investors	**11,211**	**100%**	**10,822**	**100%**	**11,912**	**100%**

16. Pension funds were responsible for 16% of funds raised by BVCA members in 2015 but the proportion from UK pension funds was only 6%. In previous years, this proportion was even lower as the table above shows.

17. From a regulatory perspective, the rules governing marketing to retail investors will be more prescriptive and detailed than those relating to professional investors given their differing risk profile. The definition of a professional investor is contained within the Markets in Financial Instruments Directive ("MiFID"). MiFID II is currently being implemented in the UK and under this, local authority pension funds will be categorised as retail investors, which will make it more difficult for them to invest in venture capital funds. Although, MiFID II includes an 'opt-up' regime, allowing certain retail investors to opt-up to professional status, the FCA's recent consultation on the implementation of MiFID II proposes to increase the minimum portfolio size required for local authority pension funds to do this.

18. The opt-up test, which includes criteria related to the frequency of transactions made by the investor in the relevant market, is already difficult to meet for infrequently traded illiquid investments such as venture capital. The FCA's change compounds this difficulty for local government pension funds and this is an area we are working on with the FCA and the Local Government Association.

19. The shift from Defined Benefit ("DB") plans to Defined Contribution ("DC") plans that is currently underway in the pension sector will have a significant impact on both private equity fund managers and, potentially, pension fund holders. As a generation emerges to whom DB schemes are unavailable, it is important that the investment opportunities that are available to DB funds are not closed to those who can invest only into DC schemes. The BVCA published a paper[7] in Autumn 2016 setting out the challenges for DC funds investing in private equity and venture capital funds including the need for a fund vehicle that provides DC funds with liquidity and daily pricing.

20. In addition, there is a regulatory 'charge cap' on the fees and administrative expenses (0.75%) that can be borne by investors in default funds that are set up by employers to meet their automatic enrolment duties. This has driven many of the default funds towards passive investment to keep the charges within the cap and the ability to invest in private equity and venture capital funds is limited given fee structures. This is an area which will need to be reviewed by the Government.

21. Insurers are also significant investors, providing 9% of funds raised by BVCA members in 2015. Again the proportion from UK insurers was low at just 2% (and nil the preceding two years). This could be increased by liberalising the capital charges placed on venture capital investments under the Solvency II framework. The European Commission is planning to address this issue as part of the Capital Markets Union initiative, and it should also be examined by the UK Government as financial regulation reverts to domestic control.

The role of the British Business Bank

22. Although relatively new, the British Business Bank ("BBB") has played an important part in developing the UK venture capital market, and developing a new cohort of talented fund managers through its Enterprise Capital Funds and Venture Capital Catalyst Programme.

23. The BBB could play an important role in bringing the UK venture capital market to critical mass. At present, there are a limited number of venture capital fund managers in the UK that have the capacity to manage funds of the scale required to provide effective financing to scale ups and to attract substantial institutional investment. A key priority for the BBB should be developing those fund managers in its portfolio that are generating strong returns into larger, better-established players.

24. Helping managers reach sufficient scale would enable them to be able to stay invested in companies over the long-term, including through the later funding rounds associated with scaling up, and would, eventually, enable managers to be able rely on private institutional money rather than the state. The BBB can play a crucial role in drawing institutional investment

[7] BVCA paper on Private Equity's place in defined contribution schemes – available here

into UK venture, growth and lower mid-market funds as a respected cornerstone investor and support the size of fund managers as an investor in successor funds.

The European Investment Fund and Brexit

25. A key risk to the development of the UK venture capital, growth and lower-mid market funds industry is the possible loss of funding from the European Investment Fund ("EIF") because of the UK's departure from the EU. The EIF is an extremely important investor in UK venture, growth and mid-market funds. Between 2011 and 2015, the EIF directly invested €2.3 billion into UK funds across different funding stages. This is significantly more than the amounts currently committed to funds by the BBB. Given the difficulty UK and European firms face in attracting commitments from private investors, the EIF's departure would harm the development of the UK's venture capital market, as well as the growth and lower mid- markets, if this level and scope of funding were not replaced by the Government.

26. The natural domestic body to take on the important and necessary role that the EIF has had in the UK market is the British Business Bank. We were therefore extremely encouraged by the Government's decision to commit additional funding to the BBB's venture capital programmes at the 2016 Autumn Statement. The Government should continue to give the BBB the necessary resources, both in terms of capital for investment and funding for operational needs, to reach the scale necessary to replace the EIF.

27. Alongside additional funding, the Government and the British Business Bank should take into account the factors below when designing the mechanism for channelling investment into the UK venture capital industry that will over time supersede the EIF. We believe that the BBB could excel in this role, helping to create a burgeoning venture capital market in the UK that is less dependent on state intervention than at present.

28. **Long-term policy stability** – The EIF has developed a reputation as a long-term, stable investor since its inception in 1994. The BBB, by contrast, is a relatively new body, with origins in older government policies and initiatives. In order to encourage institutional investment and maximise its impact, the BBB needs to be viewed as a permanent investor that will support the UK venture capital and private equity market over the long term, and its approach should not alter with changes in Government policy. To do this, the Government should commit to the principle that the BBB's capital should be permanent, and reinvested into new investments as previous investments come to fruition.

29. The Government should also consider diluting its shareholding in the BBB. 12% of the EIF is owned by various financial institutions from EU Member States and Turkey, which helps maintain its relative independence from European politics. Offering new shares in the BBB to private financial institutions would not only help put the BBB on a similar independent footing, it would also provide a source of new capital for investment into the economy.

30. **A liberal investment mandate –** The EIF has a relatively wide investment mandate, investing in funds that back companies across Europe and the wider world, and across different stages, from seed and venture, to growth and lower-mid-market funds. The British Business Bank should consider replicating this liberal investment mandate when reviewing its own approach. This is because, as indicated above, one of the long-term barriers to attracting more investment into the UK venture capital market has been perceptions of poor returns. One way of addressing this obstacle is to ensure fund managers have the maximum flexibility to invest in companies that

will generate strong returns for their investors (including the BBB and the UK taxpayer). An investment mandate that is not overly restrictive will help facilitate this and in turn support the objective of making the UK industry less reliant on government funding.

31. **Promoting the British Business Bank's reputation as a savvy, commercial investor –** It would be hugely beneficial for the UK industry if the BBB could evolve into an organisation that leads and encourages private investors, as well as being a significant investor in its own right.

32. The BBB will need to grow to match the scale and volume of investment previously committed by the EIF and look at the approach taken by other larger, established investors in areas such as due diligence and the expertise of the team. Developing a strong track record and being commercial in its approach will ensure the BBB's investment activities are sustainable over the longer term. The BVCA and the BBB are in regular dialogue on this subject with firms in the venture capital, growth and mid-market funds industry.

33. We would also encourage the Government to take steps to allow the EIF to continue investing in UK funds post-Brexit. This would likely need to be either indirectly via a continued investment by the UK in the European Investment Bank or through a direct investment by UK into EIF. It will also ensure funding continues during the period the BBB scales up its investment activities.

Venture capital tax incentive schemes

34. While institutional investment is key for larger deals, significant sums have also been raised from retail investors through the Venture Capital Schemes (EIS, SEIS and VCTs), which have played an important role in providing early stage funding for companies. Venture Capital Trusts alone have £3.9bn under management, and have raised £1.4bn for small companies in the last three years.[8]

35. The schemes—particularly VCTs owing to the evergreen structure of most VCT funds—could, in principle, be geared towards providing longer-term patient capital. Indeed, there are already a number of VCTs that have sufficient scale to provide substantial funding over multiple investment rounds. However, VCTs are restricted by the European Union's State Aid rules, which are ill suited to targeting money at scale-ups. One of the opportunities that will arise from the UK's departure from the European Union will be to improve the rules, and better target the Venture Capital Schemes towards instances of market failure, particularly the gap in scale up funding.

36. In contrast to start-ups, scale-ups are not necessarily new companies, therefore the restrictions on investments in companies older than 7 years are particularly badly targeted at driving money into scale ups. Scale ups are simply companies with the potential and desire to achieve rapid growth, which frequently arises in older firms through technological breakthroughs, market shifts or changes in ownership or management (especially in family businesses). A recent British Business Bank analysis of firms that receive growth capital, for example, found them to be, on average, 10 years old.[9] The rules of the Venture Capital Schemes should reflect this fact.

37. The restrictions on replacement capital are also a barrier to the schemes funding scale up businesses. Many founders and entrepreneurs have the skills and experience to manage the process of scaling a business from start up to scale. Clearly, however, the skills required to found

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[8] AIC VCT fundraising statistics – available here

[9] British Business Bank, Small Business Finance Markets report – available here (page 57)

and run a small business are not the same as the skills required to run a larger, more mature business. It is therefore possible for the growth prospects of a business to be constrained if it grows faster than the capacities of its management team, particularly in the case of high growth businesses. In these cases, flexibility to use replacement capital is needed to give founders the option of an exit, allowing a more experienced management team with capacity to bring the business to scale to be brought in.

38. The caps on the amounts that can be raised by firms under the Venture Capital Schemes are also an obstacle to funding scale ups. At present a company may not receive more than £5m per annum, and no more than £12m in total, from the combined Venture Capital Schemes. However, later stage funding rounds are likely to require significantly more than the £5m currently allowed in a single year—the Scale Up Institute, for example, found that the average amount invested in Series B rounds in the UK was $17m. The ability of fund managers using the schemes to stay invested over multiple rounds is further curtailed by the £12m cap on total investment.

39. Finally, the “excluded activities” that are not eligible for tax relief should be re-examined to ensure sectors in which the UK enjoys a comparative advantage are not denied funding. The restriction on financial services, for example, does not play to the UK’s strengths. Given that a number of the UK ‘unicorns’ that have successfully scaled up into large businesses are in the fintech space, this restriction should be removed.