BVCA Budget Submission 2011

EXECUTIVE SUMMARY

The private equity and venture capital industry is confident that we can help deliver economic growth with the capital we are currently looking to invest as well as the growth potential of our existing portfolio companies. 70% of the businesses we back are expecting turnover to increase and 40% are expecting to create new jobs so there is certainly cause for optimism. We need to do all we can as an industry and with Government support to attract more investment so that we can grow more companies and create more jobs. Below are some proposals that will help us to do that.

- **Appoint a Government champion to attract more private sector investors into private venture capital funds as well as part publicly funded venture schemes like UKIIF, ECFs and even the Business Growth Fund**. Public money has been successfully deployed into these areas with the exception of the BGF but we recognise the constraints we now operate under. Instead of more capital, a Government 'Venture Czar' should be appointed to seek out new investors into schemes and private funds to complement further the public money in place, particularly from Sovereign Wealth Funds

- **Bridge the gap between a strong research base and fully commercialised investment-ready businesses – make both the Olympic Park and the Pfizer site Technology and Innovation Centres.** The BVCA is already operating in Sandwich, training scientists who want to spin out companies from Pfizer's operation. But in order to get best use out of the assets there, we believe it could be turned into a TIC, providing proper links with businesses and academia, as can the Olympic Park. London has more 'Top 100 Universities' than any other city as well as burgeoning start-up communities in places like Shoreditch. There is a great opportunity to increase the commercialisation of what is an already strong research base in the way that UCL and Imperial are already doing.

- **A sensible tax regime that encourages entrepreneurship. We need to reform VCTS and EIS to maintain the UK's position as Europe's centre of venture capital activity.** The Government should focus incentives towards seed funding where we have seen a drop of 50% since 2005. But just as important an issue is the lack of follow-on funding. Too often Britain has failed to create the next Google because the funding is not there on subsequent rounds and companies are acquired by foreign competitors instead of growing organically. So we propose a boost in tax relief to 50% for start up investment with the same benefit extended to later stage funding rounds for those already invested. The state aid rules should be lifted to allow more flexible investment. France is on the cusp of overtaking the UK as the leading centre for venture capital in Europe, primarily because it applies these restrictions more liberally to their equivalent schemes.

- **Establish the UK as a centre of entrepreneurship in Europe.** With the rise of the BRICs, the N11 and even Africa, Europe is sleeping. Only the UK has the depth of VC expertise to wake it up. The AIFMD was a retrograde step, despite the strong negotiating stance provided by the UK Government. It is imperative that a single market for cross border venture capital is established and on that basis exemptions are still needed on capital and liquidity to ease the compliance burden of opting into the Directive. The BVCA welcomes the EU 2020 strategy that pushes for a pan-EU venture fund of funds. We believe that UKIIF was good for the UK as the focal point for European venture capital and this approach can now be broadened to incorporate more FoF managers with proven track records.

Financing Innovation and Growth: a New Deal for Entrepreneurs

About the BVCA: The British Private Equity & Venture Capital Association (BVCA) is the industry body and public policy advocate for the private equity and venture capital industry in the UK.

The BVCA Membership comprises over 230 private equity, midmarket and venture capital firms with an accumulated total of approximately £32 billion funds under management; as well as over 220 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

As a result of the BVCA's activity and reputation-building efforts, private equity and venture capital today have a public face. Venture capital is behind some of the most cutting-edge innovations coming out of the UK that many of us take for granted: the medical diagnostic services we use in hospitals, the chips in our mobile phones, the manufactured components of our cars, and the bioethanol fuels that may run them in the future. Likewise, private equity is behind a range of recognisable High Street brands, such as Phones4U, Birds Eye, National Grid and Travelodge.

Introduction: The 2011 Budget comes at a critical point for the UK economy. The BVCA supported the Government's actions on deficit reduction through last year's Emergency Budget and the Comprehensive Spending Review and continues to hold that view. But with public sector employment in decline, we must do all we can to support private sector job creation. In a survey conducted by peopleperhour.com, 45% of respondents believe that after deficit reduction, the next highest government priority should be 'promoting and investing in an enterprise led recovery'. The balance sheets of UK banks are in a delicate position. Despite Government efforts, there is little consistent evidence of increased lending to small and medium sized enterprises (SMEs.) Venture capital and private equity will provide a key role in the UK's recovery. Private equity and venture capital encourage, supplement and replace bank lending a critical points in the financing cycle. Regardless of scale of investment, we invest in entrepreneurs and growth. We leave businesses in a better state than we found them. Venture capital's role here is more important now than ever. Senior managers of private equity backed businesses are confident that their companies will grow significantly over the next year, with almost 70% expecting turnover to increase and over 40% predicting employment growth[1].

We set out below a partnership between Government and private equity and venture capital that will get finance into the hands of entrepreneurs and SMEs. They are the ones who will return our economy to sustainable economic growth.

[1] What to business managers think about private equity and venture capital? – BVCA 2010, http://admin.bvca.co.uk/library/documents/FINAL_dtp_report1.pdf

BVCA support for entrepreneurs

Case Study – Picochip

Picochip is a fabless semiconductor company based in Bath that provides technology which is revolutionizing the way cellular networks are built. The company has pioneered the concept of femtocells - low-cost cellular basestations that dramatically change the economics of building and running a mobile network. The company has 170 employees, of which approximately 100 are based in Bath and a further 60 in a software development centre in Beijing. Picochip has secured over $100m in venture funding from leading funds and has secured strategic investments from AT&T, Intel, and Samsung.

Picochip has a strong management team headed by CEO Nigel Toon, who has a track record in successfully building major semiconductor businesses and a Board of Directors headed by Chairman, Jonathan Brooks who was formerly CFO at ARM Holdings, one of the UK's most successful technology companies.

What can government do to foster growth in SMEs and in particular in technology?

R&D tax credits: *It is not the role of government to select winners. Incentives should be structured to support business investment. At Picochip we have built a position of leadership in our chosen markets by investing heavily in advanced research and development (R&D) and have created a world beating technology that is defining a new market segment. Semiconductor companies typically invest 20% to 30% of their revenues into R&D. For growth companies such as Picochip which is competing in a global market, R&D tax credits have provided a significant cash flow advantage. These schemes must be maintained and further enhancements could be made, specifically allowing more regular claims to further enhance cash flow for emerging technology companies*.

Patents and IPR: *Fast growing technology companies must choose carefully how they manage their Intellectual Property. Incentives that make it easier to protect genuine intellectual property through patents and tax incentives that value the creation of world beating IPR could significantly help technology focused businesses.*

Continue to invest in education: *A continuing supply of high-quality graduate and post-graduate recruits is essential to a growing business like ours. The continuing fall off in STEM (Science, Technology, Engineering and Maths) graduates and post-graduates is not a new concern, but it is a major issue for us and for technology firms across the country.*

Incentives for Entrepreneurs

Over time there have been schemes to promote entrepreneurship and risk taking eg the EMI and EIS schemes. But the current trend seems to be towards flatter CGT rates, putting the rewards of starting a high-risk / high-growth business on a par with other forms of low risk investment. This will discourage seed funding and means that less people will take the risk of developing a new technology business.

What are we offering entrepreneurs as a sector?

Over the last 3 years, around £1bn of venture capital has been invested by BVCA members into the UK, helping over 1300 high-potential companies develop and grow. In addition to this financial investment, venture capital brings significant other benefits, such as operational and financial improvements, or strategic goal setting. Recent research by the BVCA found that ninety per cent of portfolio companies believed private equity and venture capital ownership beneficial.

- **Capital and expertise –** the venture capital sector represents a professional body of fund managers trained to manage third party funds and provide long term guidance to portfolio companies. By actively participating as non-executive directors in the companies they invest in, venture capitalists provide expert guidance and mentoring to entrepreneurs.

- **Entrepreneur's Academy** – the BVCA in conjunction with a leading business school is looking to launch a new kind of education– a more rigorous post-graduate training programme in everything an entrepreneur needs to access finance and grow a business. We will link this up with the Government's initiative on mentoring and our ongoing work to improve information on equity finance through Business Link. There is more to be done in raising awareness in Universities and schools of the career opportunities in working for entrepreneurial companies, and in driving cultural change by showcasing entrepreneurial success. The BVCA will work with the National Consortium of University Entrepreneurs to help bring this about.

- **East London Tech City** – we are offering our active assistance and support for this initiative via the Mayor of London's office – expertise, infrastructure and finance

- **Support for commercialising university research** – the UK has a strong research base but is less good at turning this into commercial activity. Whether through Technology and Innovation Centres, enterprise zones or clusters, the BVCA believes there is scope for intervention

- **Regional investment** - The BVCA shares the Government's desire to create more private sector jobs in the regions, particularly those who will be most challenged by public spending restraint. As a sector we have a strong regional presence and so are well placed to do this through an angel co-investment fund, enterprise capital funds or assisting the banks in implementing the Business Growth Fund

- **Diversification:** we can help deliver growth in new sectors outside financial services. The Government has rightly stopped short of picking winners but with appropriate support, we can deliver growth in new sectors that play to Britain's considerable strengths.

How Government can enable us to do more?

Case Study: Andy Phillips – Business Angel

I co-founded my first business in 1999, raised capital from a VCT and grew the company to become the largest hotel booking company online in Europe (Active Hotels). We won a number of awards, including the fastest growing company in the UK (Deloitte), emerging entrepreneur of the year (EY) and Sunday Times best employer. Following its sale in 2004 for $161 million to Priceline at a return of over 1000% to investors, I have helped set-up and/or invested in over ten businesses with a focus on Cleantech and ecommerce. I also teach entrepreneurship at INSEAD and LBS.

What can Government do to help Angels and entrepreneurs?

- *Unlike the United States, SMEs have traditionally found it very difficult to access the public sector, which has become such a significant part of our economy. This has caused a knock-on effect, whereby private capital is very reluctant to invest in new businesses that could bring greater efficiency to government functions. With budgets being reduced, greater efficiency is urgently needed and a shake-up of procurement procedures to help small businesses compete could bring major benefits.*
- *The EIS framework is attractive to business angels, but under the current framework it is difficult to structure convertible loans or preference share investments. This is reducing the options for seed investors, as well as suppressing the appetite to take subsequent venture capital, which will impose such structures to the detriment of the existing investors.*
- *Early stage companies can often benefit from non-exec directors, mentoring or advice from people with experience in their areas. Opening up the employee management incentive scheme (EMIS) to advisors or non-execs could help accelerate this mentoring provision.*
- *Maintaining sources of expansion capital, such as VCT, ECF and VCs to ensure a variety of finance and the associated management rigour is available to build global companies rapidly and for the long term.*

BVCA Recommendations

Appoint a Government champion to attract more private sector investors into private venture capital as well as part publically funded venture schemes like UKIIF, ECFs and the Business Growth Fund. Public money has been successfully deployed into these areas with the exception of the BGF but we recognise the constraints we now operate under. Instead of more capital, a Government 'Venture Czar' should be appointed to seek out new investors into schemes and funds to complement the public money in place. For example, Sovereign Wealth Funds do not currently invest in the asset class but with the right engagement from UKTI this could change. With the BVCA's 'Year of Venture' now underway, the profile of the sector is increasing and a champion within Government could work effectively alongside this initiative.

Bridge the gap between a strong research base and fully commercialised investment ready businesses – make the Olympic Park and the Pfizer site Technology and Innovation Centres. With the strategic shift from in-house research to greater use of small organisations in partnership with academia there is a clear case to deploy TIC money on the Pfizer site to help facilitate this transition. Similarly with the Olympic Park - London has more 'Top 100 Universities' than any other city as well as a burgeoning start-up community in places like Shoreditch. There is a great opportunity to increase the commercialisation of what is an already a strong research base in the way that UCL and Imperial are already doing.

The £200m for Technology and Innovation Centres is welcome but before being deployed, an audit of existing provision is essential so that there is a clear understanding of coverage and best practice. This may involve investing in new standalone institutions or it may involve adding to existing capacity. This emphasis was also endorsed by the Science and Technology Committee's recent report.[2] In addition to strong industrial partners, we would stress the importance of universities as a leading source of the intellectual property needed to provide product for these centres to develop and commercialise. We stress the importance of venture capital, both in its experience of helping universities to turn their IPR into viable businesses, and to funding those businesses through growth to profitability. We see TICs, with their capital intensive facilities, as a nexus where industry, university and venture capital can meet to foster growth and innovation.

Support regional provision of capital by a Regional Growth Fund for angel co-investment. This would involve both public and private sector co-investment through a regional fund to provide vital support for small businesses in those regions that most need investment. The Regional Growth Fund would co-invest with established and approved angel networks in selected regions on a deal-by-deal basis, thus supporting private sector involvement in small enterprises.

Establish the UK as a centre of entrepreneurship in Europe. With the rise of the BRICs, the N11 and even Africa, Europe is sleeping. Only the UK has the depth of VC expertise to wake it up.

[2] See http://www.publications.parliament.uk/pa/cm201011/cmselect/cmsctech/619/619.pdf

The AIFMD was a retrograde step, despite the strong negotiating stance provided by the UK Government. It is imperative that a single market for cross border venture capital is established and on that basis exemptions are still needed on capital and liquidity to ease the compliance burden of opting into the Directive.

The BVCA welcomes the EU 2020 strategy proposing pan-EU venture fund of funds. We believe that UKIIF was good for the UK as the focal point for European venture capital and this approach can now be broadened to incorporate more FoF managers with proven track records.

A sensible tax regime that encourages entrepreneurship. We welcome the Government's plans for a simple and stable tax regime. We will work with the Office of Tax Simplification to reform and retarget a system of tax reliefs that encourages both investors and entrepreneurs themselves to create and grow successful businesses.

Whilst investment in venture capital has largely held up in recent years, there has been a move away from seed and start-up funding, as venture capital funds look for fewer risky investments in the wake of the financial crisis. Between 2007 and 2009, BVCA statistics show that seed investments have fallen by around two-thirds, and start-up investments by over 90%. This is exacerbating the problem of the equity gap at the lower end of the market. So what can be done?

Entrepreneur's relief

The Coalition recognises the importance of business angels in the provision of equity finance to SMEs. In order to encourage them further, and to reward them for the considerable risks that they undertake, we recommend a relaxation of Entrepreneurs Relief rules to cover, a) angels and other non-employee private individuals who invest at risk, and b) employees who have less than a 5% equity stake. This could be achieved by removing the employment requirement and the 5% minimum holding requirement. We would also encourage a lifting of the £5 million lifetime gain cap, to encourage greater aspiration for growth. As mentioned above, fund managers provide vital expertise and mentoring services as non-executive directors and should be incentivised accordingly.

EMI (option) scheme

The EMI scheme is used extensively and successfully to encourage the use of options to motivate employees in small companies. There are however, unhelpful limitations placed on individuals and on the scale of grants which inhibit its usefulness. For instance scientific founders (often academics) and active NEDs can be excluded because they do not meet the current 'employment' test. In addition, high calibre CEOs can be deterred from committing to a high potential SME because of limits on individual option grants.

●We therefore propose that current requirements for recipients of EMI option grants to have worked minimum number of hours with the relevant company be substantially reduced.

●We also propose that limits on the value of individual option grants under the EMI scheme should be increased from £120,000 to £750,000 (within the context of an overall £3 million cap at the company level which we would not propose to change). EMI schemes should be made available to both non-executive directors and part-time employees.

●We further propose that the Entrepreneur's Relief rate should apply to share gains under EMI schemes.

VCT/EIS

The Coalition has shown continuing support for Venture Capital Trusts (VCTs) and the Enterprise Investment Schemes (EIS). We have strong evidence to show their effectiveness in providing finance for SMEs, particularly at a time when banks' reluctance to lend to the sector shows little signs of abating. The valuable role of VCTs (and, by implication, EIS) in creating employment and in providing a strong return on the Treasury's investment has been detailed in the March 2010 report prepared by the Association of Investment Companies "Supporting Enterprise and Growth: the Role of Venture Capital Trusts". The report shows an increase in the workforce amongst 303 investee companies of 47%, while the total annual tax return by the sample investee companies amounted to some 67% of the tax cost.

To strengthen the scheme further we propose a re-launching of VCT and EIS by ensuring that investments are more closely targeted to the policy objectives of encouraging innovation and enterprise, and by increasing the tax reliefs to reward risk taking and long term investment. For EIS we would propose that income tax relief of a higher level of 50% be available for total investments of up to £1 million in individual companies with net assets of under £1 million. For VCTs we would propose that, in addition to the existing 30% income tax relief on investment, investors be encouraged to invest for the long term, enabling multiple usage of their funds by making available similar for follow on funding further down the line.

The current EU imposed rules whereby new funds raised by VCTs and EIS could only be invested in companies with fewer than 50 full-time employees, and whereby companies cannot raise more than £2 million, are not helpful in helping companies access the VCT and EIS funds that are currently available. With this in mind, in the Budget of 24 March 2010, the then Chancellor stated that HMRC and Treasury would work towards trying to increase the employee limits to 100 or 250, and the annual investment limit to £5 million. We strongly urge the new Government to continue with this process and to extend the annual investment limit in line with its views of the Equity Gap. This would enable VCTs to invest in any company defined by the European Union as an SME, and further enable VCTs to fulfil their core role of helping to close the Equity Gap. In addition, the "gross assets" test limiting the size of company in which VCTs and EIS can invest, should be increased from "gross" assets of £7 million to the previous value of £15m or alternatively one based on enterprise value as proposed by the EU.

We are also in favour of broadening the range of all securities in which the EIS can invest. Examples of securities currently not permitted include loan stocks and preference shares. A broadening of the range would ensure that there is no conflict with instruments provided by other forms of VC finance. This would not only match the Government's broad aim of encouraging more syndication to enable larger deal sizes, but would also enable early stage EIS investors to "follow their money" by investing in later stage VC rounds.

Additional support for Venture fund of funds

The UK Innovation Investment Fund (UKIIF) provided a valuable start in assisting venture funds to raise institutional money at a time of unparalleled difficulty in fundraising. We do, however, think that more could be done in this area. First, we would ask Government to assist in encouraging one or more sovereign wealth funds to join in the UKIIF initiative. Second, we would request that the UKIIF be made eligible for ISA and SIPP investment so that private investors can also participate in larger venture funds spread across multiple managers and sectors.

R and D tax credits

We would like to emphasise the importance of R and D tax credits to SMEs as a source of critical funding as well as encouragement to innovation. These tax credits have proved, over recent years, to be an excellent and well-targeted source of investment finance, and have had a material effect in improving the UK's technology base.

We understand concerns that these credits should continue to be targeted at appropriate projects and activities, though we would urge caution to prevent any further targeting from being overly restrictive. We do, however, strongly support the recommendation in the Dyson Review that the rate for small enterprises should be increased to 200%.

Patent Box

We strongly support the proposals for the patent box which we see as being a helpful and imaginative way of encouraging innovation in intellectual property. We do have a number of detailed comments on the proposals which we will be submitting in a separate paper

Disguised Remuneration

The BVCA recognises that at a time of public spending restraint, people are entitled to ask legitimate questions about fairness in the tax system. On that basis we support measures to close loopholes where trusts and other vehicles are being used to ensure that conventional remuneration does not incur income tax and national insurance charges.

But in attempting to shut down certain schemes using Employer Benefit Trusts or Employer-Funded Retirement Benefit Schemes there is a danger that investment activity, whether in

the form of co-investment, carried interest or management equity, will incur income tax charges or, at the very least, create legal uncertainty that they might – this will have a detrimental effect on investment flow at the worst possible time.
We need to send the clearest message of support to all would be investors and entrepreneurs.

There is also a real danger that the rules as currently drafted will catch a host of simple, innocent arrangements, or at the very least introduce huge uncertainty for just the sort of companies that need encouragement at this time to focus on growth.

In the run up to the end of the financial year there is an acute need to reduce uncertainty and on that basis, a clear statement of intent on current structures is essential. Instruments covered by the existing restricted securities legislation should be explicitly excluded from these measures.