Industrial Strategy Team
Department for Business, Energy and Industrial Strategy
1 Victoria Street
London
SW1H 0ET

By email: industrial.strategy@beis.gov.uk

17 April 2017

Dear Sirs,

Re: Building our Industrial Strategy – BVCA response to the Green Paper

1. We are writing on behalf of the British Private Equity and Venture Capital Association ("BVCA"), which 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. We welcome the opportunity to comment on the questions posed in the Industrial Strategy Green Paper. With the UK's departure from the European Union on the horizon, it is vital that the economy is prepared for the challenges ahead by enhancing our competitiveness and productivity. Enabling greater investment and supporting innovative businesses will be central to this effort, and we will set out how the Government can positively contribute below.

3. The BVCA response primarily focuses on two pillars of the Industrial Strategy – pillar 1: investing in science, research and innovation, and pillar 4: supporting businesses to start and grow. We also include some comments on pillar 7. Prior to addressing the questions in the Green Paper, we first set out further information about the private equity and venture capital industry, detailing the investment model and the positive impact of private equity and venture capital investment on the UK economy.

4. We have previously met with representatives from BEIS to discuss the work of our industry and would be delighted to meet you again to discuss this response in further detail.

A. Executive summary

5. The UK's private equity and venture capital industry is well placed to support the Government's industrial strategy and make the UK one of the most competitive places in the world to start or grow a business. Our members are long-term investors that seek to develop sustainable businesses across the UK.

6. The decision by the UK to leave the European Union brings with it a period of uncertainty for our members and the businesses in which they invest. We believe that the Government can create the right regulatory, tax and fiscal incentives to support business and for private equity and venture capital firms. This means ensuring the UK's asset management industry is globally

competitive and that the UK remains an attractive place to set up a fund manager, invest and conduct asset management activities. A competitive asset management sector also benefits the wider industries that rely upon a thriving private equity and venture capital sector, including banking, administration, legal, audit and other professional services.

7. The success of the UK as a leading destination for private equity and venture capital firms has been driven by our ability to attract talented individuals who work within the firms themselves as well as the underlying portfolio companies in which the industry invests. As the UK leaves the EU, it will also be important for the country to continue to attract the best international talent.

8. Private equity and venture capital are vital components of the funding ecosystem for innovative businesses. This activity depends on the UK maintaining an economic environment that is well disposed to investing in R&D and intellectual property more broadly. The networks of universities and businesses with particular sector specialisms that will survive and thrive are those that already exist at least in a nascent form across the country. The Government should not seek to establish regional educational/industrial clusters where they do not exist organically. The Catapult Centres have been successful in leveraging the potential of clusters and collaboration on R&D between universities and the investment community. These should continue to be properly funded with added emphasis on building networks between industry and universities. Changes to the R&D tax credit have been welcomed by our members but the funding committed as part of the EU Horizon 2020 programme should continue after we leave the EU.

9. 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. Driving more institutional investment into UK funds would ensure that the industry reaches sufficient scale. As well as reviewing regulatory barriers, we believe the British Business Bank should play a vital role in drawing in private capital through increased investment in venture capital funds. We welcome the additional funding committed by the Government in the Autumn Statement 2016, however, this level of funding must increase to match that currently provided by the European Investment Fund.

10. The BVCA also believes there is scope for further encouraging the role of mission-led business in delivering a more inclusive and sustainable economy and catalysing business to solve societal challenges.

B. About the private equity and venture capital industry

Key features of private equity and venture capital

11. The UK has an active private equity and venture capital market which raises capital from investors and invests it globally. Private equity and venture capital firms are long-term investors, typically investing in unquoted companies for around three to seven years. Firms will often sell their stake in a company by listing on the public markets or selling to a strategic buyer.

12. There are three key stages of the private equity and venture capital investment cycle:

    a. **Fundraising**, during which managers raise capital from investors. These investors are typically institutional or professional investors such as pension funds and insurance companies.
    b. **Investment**, during which managers source deals and put capital to work by investing in companies that are typically unquoted and SMEs, investing alongside management and founders and supporting these companies through their development and growth.
    c. **Exit**, selling or realising investments and providing returns for investors.

    Barriers that make any of these stages more difficult or costly therefore impede the ability of our members to invest in and provide other support to UK companies in an efficient manner. Our response to the green paper is based on feedback we have received from firms on the challenges encountered during the different stages of the investment lifecycle.

Investment into UK businesses and employment

13. Private equity and venture capital managers generally exercise a great level of influence over the businesses they own, and undertake important strategic and operating initiatives to create value, enhance the performance of and strengthen and grow the businesses they own. Such initiatives can include professionalising the management and improving the corporate governance of a business, expanding the product portfolio or geographic reach of businesses, acquisitions to strengthen market positioning and achieve economies of scale, cost controls, process improvements and other operational efficiencies. There is a commitment to build lasting and sustainable value in business and as a result generate strong returns for investors in private equity and venture capital funds, as highlighted below.

14. Our members have invested over £27 billion in nearly 3,900 UK-based companies over the last five years. Private equity and venture capital funds managed in the UK currently back around 2,980 companies, employing over 900,000 people on a full-time equivalent basis ("FTEs") across the world. Of these, around 385,000 FTEs are employed in the UK and 333,000 are employed in the rest of the EU. In 2015, 34 companies experiencing trading difficulties were rescued by BVCA member firms, helping safeguard around 16,500 jobs.

15. Private equity and venture capital is a national investor, providing funding and strategic expertise to businesses across the country. Of the businesses invested in during 2015 in the UK, 63% were small companies, with a further 21% being medium-sized companies. The table below shows the regional impact of our members' investment activities.

Total investment by BVCA members 2013-2015

	Number of companies	%	Total investment £m	%
London	550	25%	6,184	42%
South East	311	14%	1,842	12%
South West	143	6%	863	6%

East of England	100	4%	590	4%
West Midlands	186	8%	757	5%
East Midlands	89	4%	1,051	7%
Yorkshire & The Humber	139	6%	1,528	10%
North West	249	11%	1,191	8%
North East	118	5%	147	1%
Scotland	177	8%	460	3%
Wales	116	5%	157	1%
Northern Ireland	55	2%	46	-
Total	**2,233**	**100%**	**14,819**	**100%**

16. The BVCA recently launched the latest version of its Private Equity and Venture Capital Map[1], an interactive tool which details the extent of British businesses backed by our industry. The map shows the locations of portfolio companies across the UK and sources information from Companies House to highlight revenue and employment figures. This data can be filtered by region and sector, with heat maps showing the concentration of businesses. The BVCA's website also includes case studies[2] on the investments made by our members across the UK and in different sectors including technology, manufacturing, defence, energy and finance.

17. In September 2016, we published the findings of a study we had commissioned alongside Deloitte and NorthEdge Capital that examined the role private equity can play in unlocking the potential in the North of England, which continues to lag behind London and the South East in economic growth and productivity. Highlights of the report include:
    a. Companies that receive private equity backing outperform benchmarks in productivity growth against non-private equity-backed companies by as much as 9%.
    b. This productivity outperformance is true across the whole of the UK but is strongest in the North.
    c. Productivity growth for these northern private equity-backed companies is accompanied by three-year compound annual growth rates of 5% in sales, 9% in exports and 3% in employment.
    d. Out of a total of approximately 3,300 companies identified in the UK with a strong statistical match to the 'profile' of being potentially suitable for private equity investment, there were 1,187 companies identified in the northern regions. This compares with a population of 654 existing private equity-backed companies and suggests that there is huge potential for further investment.

18. Recent independent research[3] conducted by Oxford Economics on behalf of the BVCA has demonstrated the impact of venture capital on the economy. Taking account of all investment, including UK-managed funds, there are around 9,400 VC-backed companies in the UK, contributing over £10bn to GDP and employing more than 130,000 FTEs. When taking into account supply chain and employee spending impact, the sector contributes over £20bn to

[1] BVCA Private Equity and Venture Capital Map – available here
[2] BVCA case studies – available here
[3] The contribution to the UK economy of firms using venture capital and business angel finance (Oxford Economics & BVCA, forthcoming)

GDP, and supports 326,000 jobs. The research also shows that, compared to the private sector as a whole, companies backed by venture capital and angel investment are more likely to be in high-productivity sectors such as digital, financial and health. As a result, average GDP per job in these firms is estimated to be £73,700 per annum compared to £47,500 per annum for the private sector in aggregate.

19. The wider financial and professional services industry benefits from having a competitive and successful UK private funds industry. A recent study[4] from TheCityUK looks at how and where the UK's financial and related professional services industry has evolved since the financial crisis, stating that over 200,000 jobs have been created within the sector since 2010. About 2.2 million people are now employed in the financial services industry and related professional services industry in the UK and two thirds of them work outside London.

A global leader that generates strong returns for investors

20. Investors in private equity and venture capital funds are typically institutional investors. This includes pension funds, university endowments, insurance companies, sovereign wealth funds, fund of funds, corporate investors and private individuals. The UK is a global hub for private equity and venture capital and our members have demonstrated their consistent ability to outperform other asset classes. On a since-inception basis, UK funds returned 13.8% (net of fees) in 2015, and the 10-year IRR generated 13.2% (net of fees), nearly double that of pension fund assets and the FTSE All-Share Index.[5]

C. Responses to Green Paper questions

1. Does this document identify the right areas of focus: extending our strengths; closing the gaps; and making the UK one of the most competitive places to start or grow a business?

2. Are the ten pillars suggested the right ones to tackle low productivity and unbalanced growth?

Driving investment into mission-led companies

21. The Green Paper sets out the need to build a more inclusive and sustainable economy, and we believe social impact investment could play a major role in meeting this objective. Impact investing is becoming increasingly instrumental in promoting social inclusion, providing alternative sources of employment for marginalised social groups, and contributing to growth.

22. The private equity and venture capital industry has a strong track record of driving impact in profit-with-purpose businesses and social enterprises from specialist investment firms such as Bridges Ventures and Impact Ventures UK; to mainstream private equity firms such as Bain Capital through the launch of their fund Double Impact; through to institutional investors such as Big Society Capital. We believe that equity investments are particularly well suited to the long-term nature of social organisations and private equity and venture capital investors have the experience, the capital and the skills required to scale up a social business.

[4] UK-based financial and related professional services: enabling growth across the UK, report available here

[5] BVCA Performance Measurement Survey 2015 – available here

23. The mission-led business advisory panel acknowledged in their recent report[6] the growing evidence that businesses that embrace social priorities perform better as they reflect people's ideals and ambitions relating to the role of business in the 21st century. Mission-led business therefore have a competitive advantage in the form of increased employee retention and greater customer loyalty and advocacy.

24. The BVCA believes there is scope for further encouraging the role of mission-led business in delivering a more inclusive and sustainable economy and catalysing business to solve societal challenges. This could be facilitated by introducing a new corporate form for those new businesses that are making a commitment to achieving a social as well as financial impact. There is a need to make those profit-with-purpose companies more visible to consumers and investors so that further equity capital can be deployed in UK cities through local innovative mission-led business. The Government could also broaden its support to organisations that deploy a venture capital and private equity approach to supporting social and charitable ventures, and an example of venture philanthropy is Inspiring Scotland.

25. Furthermore, by using a place-based investment approach to target underserved areas, impact investing constitutes a good lever for meeting societal objectives and contributing to regional economic development outside of London and the South East. The BVCA has mapped the location of some private equity impact investments against the Index of Multiple Deprivation, thus identifying the spill over effects of such investments for local economies and communities, particularly in underserved areas[7].

26. The UK National Advisory Board on impact investing has recommended increasing access to affordable finance for underserved communities, through a version of the U.S. Community Reinvestment Act adapted to the UK market, requiring banks to reinvest in low-income areas, or through otherwise supporting the growth of Community Development Financial Institutions serving targeted underserved areas.

Building on the UK's strength in services

27. A key focus of the Government's Industrial Strategy should be building on the UK's strength in services. Services make up almost 80% UK GDP, and the financial services sector alone contributes 11.5% of the UK Government's total tax receipts and generates a trade surplus of over £60bn.[8] The industrial strategy should therefore cover this key part of the economy.

Pillar 1 – Investing in science, research and innovation

5. What should be the priority areas for science, research and innovation investment?
6. Which challenge areas should the Industrial Strategy Challenge Fund focus on to drive maximum economic impact?
7. What else can the UK do to create an environment that supports the commercialisation of ideas?
8. How can we best support the next generation of research leaders and entrepreneurs?
9. How can we best support research and innovation strengths in local areas?

[6] Mission-led business advisory panel report - available here
[7] BVCA investment agenda campaign, social impact investing – available here
[8] TheCityUK report available here and the City of London Corporation report available here

28. Private equity and venture capital are a vital component of the funding ecosystem for innovative businesses. From early seed stage investments to large buyouts, our members provide capital and expertise enabling pioneering breakthroughs, resource and capital intensive research and product development. As we have highlighted in previous consultation responses, this activity depends on the UK maintaining an economic environment that is well disposed to investing in R&D and intellectual property more broadly. We therefore welcome the Government's statement that it is committed to pursuing a 'major upgrade' in the role of research and innovation across the country.

29. This effort will require addressing several interconnected issues. As mentioned in the Green Paper, the UK's average R&D spending currently sits at 1.7% of GDP, below the OECD average of 2.4%. This underinvestment is also made clear in the EU Industrial R&D Investment Scoreboard, which features 16 British companies in the top 100, compared to 24 from Germany and 20 from France.[9] Other concerns relate to increasing the rate at which universities translate research into commercial opportunities, uncertainty regarding R&D funding after the UK leaves the EU, and the continued ability of the country to attract high-skilled individuals from Europe and further afield.

30. As the Government develops policies to tackle these problems, it should ensure that it is not drawn to 'find' the UK's Silicon Valley or establish regional educational/industrial clusters where they do not organically exist. The networks of universities and businesses with particular sector specialisms that will survive and thrive are those that already exist at least in a nascent form. As we will demonstrate below, there is a role to be played by government in supporting R&D when it acts to convene individuals and institutions with similar interests, and underpins innovation through direct and indirect support, financial or otherwise.

Catapult Centres

31. The Green Paper clearly sets out the Government's commitment to improve the commercialisation of research and development, and invest in local science and innovation strengths. We believe that, since their launch in 2010, the network of Catapult Centres have positively contributed to both of these aims. By providing equipment, resources, expertise and networking opportunities to businesses undertaking late stage research and development, Catapult Centres reduce the gap between research and commercial activity. Furthermore, given that Catapult Centres are established in clusters where particular sectors reach critical mass, they by definition capitalise on local strengths and create regional innovation hubs.

32. The success of the Catapult Centre network also rests on its unique funding formula, which provides a degree of state support but requires individual centres to respond to commercial drivers to source two thirds of their funding through competitive business-funded and public-private R&D contracts, rather than facing the restrictions of university research priorities channelled through public funding. This is not to undermine the importance of continued government funding for the centres, which provides financial stability for what continue to be relatively young and experimental institutions. The Government should increase funding for Catapult Centres where necessary to ensure they remain as pioneering as the companies they support, for example through the purchase of the latest machinery and equipment.

[9] EC Joint Research Centre EU Industrial R&D Investment Scoreboard 2016 - available here

33. Discussions with stakeholders have, however, highlighted that knowledge and understanding of the role of the Catapult Centres remains limited. In particular, there needs to be a more concerted effort to interface with investors and entrepreneurs, and the broader investment community, to ensure that as many innovative firms as possible have access to the support they provide. Notably the Digital and High Value Manufacturing Catapults have been cited as 'flagships' in this regard, having set out a clear engagement strategy. We have also received similar comments regarding interaction between the Catapult Centres and universities, with the Cell Therapy Catapult noted for actively feeding back information about research avenues worth pursuing in light of ongoing commercial R&D.

34. In our 2014 submission to the Hauser Review, we stated that the Catapult Centres' impact was also limited by their focus on late-stage development. We believe that this needs to be adapted with more recognition and support provided for early research phases. This would allow Catapults to ensure that promising blue skies research moves closer to commercialisation. Given the networking, expertise and resources already provided by Catapult Centres, provision for assisting early-stage firms may be partly in place. As suggested above, this could be greatly enhanced if entrepreneurs and venture capital firms were more involved in the centres. There remain concerns that Catapult Centres risk becoming 'big R&D' institutions, rather than hubs focused on stimulating the start-up activities they are intended to assist along the business development process. If this is not possible, the Government should look to re-evaluate its support for regional incubators in proximity to clusters, which provide funding and physical space to support very early stage ideas, whilst bringing together investors and interested corporates.

35. Overall, we believe that the Catapult Centres have so far proved successful in leveraging the potential of clusters, encouraging useful R&D collaboration and supporting future British success stories. Key to taking advantage of new technologies and products is ensuring the leveraging of the investment community and universities around properly funded, industry-led hubs. We hope the Government continues to recognise the potential of the Catapult Centres, and their potential to become as influential and impactful as the German Fraunhofer centres on which they are based.

Universities and entrepreneurship

36. The UK remains a global leader in higher education and its universities continue to engage in cutting edge research across many fields of study. For the Government to fulfil its policy aim of developing an economy which takes full advantage of this strength, our universities need to become more aligned with commercial opportunities for research, whilst providing more support for entrepreneurialism within their student bodies.

37. In relation to the first issue, many academic institutions remain distant from companies that interface with science, largely due to their substantial control over R&D grant funding which lacks commercial drivers. Investors also remain restricted from funding university-based innovation due to ownership restrictions on intellectual property. We therefore welcome the Government's commitments in the Green Paper to commission independent research into approaches to commercialisation, and a review of the incentives created by the current Intellectual Property System.

38. In 2014, the BVCA sponsored a RSA City Growth Commission study, which highlighted a number of ways in which university contribution to economic growth through enterprise could be improved.[10] These include:

   a. Building networks between people and institutions
      i. Encouraging higher education institutions to co-invest with business improvement districts and industry partners to support start up incubation and acceleration space located in innovative urban districts, following successful models such as Engine Shed (Bristol), Northern Design Centre (Gateshead), C4DI (Hull), Collective (Camden, London) and the Hatchery (UCL, London). Higher education institutions in major cities should consider investing in such schemes.
      ii. Leveraging the finance and expertise of university resources, to invest in spin-off enterprises. Such funding rounds could support initiatives which link students and graduates with mentorship among staff, alumni and business partners.
   b. Embedding entrepreneurialism at university
      i. Universities should invest in the Entrepreneur First model of seed investment programmes, selecting on the basis of technical talent in STEM subjects, usually before they have a team or a start-up idea.
      ii. Expand flexible course provision with universities allowing sandwich years for employment and enterprise, access to an enterprise module, and modular courses where possible to provide flexibility for short-term placements at short notice.

R&D funding and tax incentives

39. The Autumn Statement 2016 and Spring Budget 2017 were notable for their focus on research and development. The new Industrial Strategy Challenge Fund, additional funding for research capacity and business innovation, and measures to reduce the administrative burden of R&D tax credit were all welcomed by the BVCA. Nevertheless, there remains a degree of uncertainty for those making use of EU Horizon 2020 funding in this space, and regarding the direction of the new government body for the sector, UK Research and Innovation.

40. Whilst the Government has confirmed that it will underwrite Horizon 2020 grants made up until the UK leaves the EU, more clarity is required about the framework, if any, that will replace it. The Industrial Strategy Challenge Fund appears to be an obvious candidate for this role, but we would expect clarification on this matter during the forthcoming negotiations. Furthermore, given the participation in Horizon 2020 by a number of non-EU countries, it may not be necessary for the UK to leave the programme at all. Whatever the eventual outcome, it is of utmost importance that current funding levels for UK R&D are not reduced beyond 2020. Such an eventuality would likely prove highly damaging to the very sectors that the Government hopes will be key exporters after Brexit occurs and new global trade deals are in place.

41. As noted in our comments on universities and entrepreneurship, universities have found it difficult to assemble the right skills and resources to commercialise their IP effectively, although there are some notable exceptions. We therefore welcome the creation of UK Research and

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[10] RSA City Growth Commission – 'Univercities' Report – available here

Innovation ("UKRI"), which will combine Innovate UK and sections of the Higher Education Funding Council for England. UKRI presents a positive opportunity to create a more joined-up approach to R&D funding with sector expertise pooled, and opportunities to improve collaboration between researchers and business, including investors. Whilst UKRI will not be operational until April 2018, we note that Innovate UK has begun to refocus on the provision of grants, moving away from commercial options, including loans, which were developed in the last Government. Clarity on this direction of travel would be appreciated.

Skills and talent development

42. If the Government is to support science, research and innovation fully, it must acknowledge the broad pipeline of talent required from the UK and abroad to do so. Within the UK, educational institutions must continue their efforts to improve the quality of STEM teaching, and the take-up of STEM subjects at college and university. Focusing on higher education, the Spring Budget 2017 included the announcement that £90m from the National Productivity Investment Fund ("NPIF") will be used to support 1,000 PhD places, with £160m provided for researcher fellowships. Encouragingly, these qualifications will be directly linked to key sectors identified in the Industrial Strategy, providing greater opportunities for the commercialisation of research and enhancing links between academia and business.

43. As the UK leaves the EU, it will be important for the country to continue to attract the best international talent. Whilst the Government has recognised this as a key issue, allocating a further £100m of NPIF funding to target international researchers, developing an innovative economy also requires inward flows of foreign entrepreneurs. In 2015, the BVCA responded to the Migration Advisory Committee ("MAC") Review of the Tier 1 Entrepreneur and Graduate Entrepreneur visa routes. Several of our recommendations were accepted by the MAC, including the creation of a 'start-up visa' whereby individuals could receive endorsement from business accelerators, and lowering the investment threshold to reflect funding requirements in some innovative sectors. The Home Office has yet to address these recommendations, and we would hope to see this take place as the UK develops its post-Brexit immigration system.

44. In common with many other parts of the UK economy, one of the challenges for private equity and venture capital firms, and the companies they invest in, is finding requisite skills on the ground. Attracting highly skilled workers and entrepreneurs to the UK, as well as allowing high-growth companies to find the skilled employees that they need and at suitable speed to make the most of their market opportunity, is an urgent priority. This includes confirming that EU nationals who are in work here already can stay to provide business with the certainty it needs. As part of our Brexit strategy, it is important that there is clarity on this issue and appropriate transitional arrangements are put in place to enable the industry to adapt accordingly and to ensure that neither private equity andventure capital funds nor their portfolio companies move operations away from the UK in the near term.

Pillar 4 – Supporting businesses to start and grow

19. What are the most important factors which constrain quoted companies and fund managers from making longer term investment decisions, and how can we best address these factors?
20. Given public sector investment already accounts for a large share of equity deals in some regions, how can we best catalyse uptake of equity capital outside the South East?

22. What are the barriers faced by those businesses that have the potential to scale-up and achieve greater growth, and how can we address these barriers? Where are the outstanding examples of business networks for fast growing firms which we could learn from or spread?

Making the UK an attractive destination to set up and manage a private equity and venture capital fund

45. Section B of this response sets out the benefits a vibrant private equity and venture capital industry brings to the UK economy in terms of investment in businesses and employment. In this section, we outline areas that we believe could further support investment across the UK and how to accelerate business growth.

46. Our policy framework must encourage inward investment and attract the best talent. Central to achieving these goals is a competitive domestic tax and regulatory regime that brings the stability and predictability that businesses and our industry needs to make long-term investment decisions. Reducing administrative burdens and costs associated with running a fund management business benefits investors and lowers the barriers for setting up firms here.

47. Over the past three years, a number of complex and fundamental changes have been introduced in the UK covering taxation and the regulation of fund managers. The cumulative effect of this on our members has been significant. We have worked closely with HMT, HMRC and the FCA on a number of different areas. We appreciate this ongoing collaboration, but believe the Government can go further to simplify taxation for corporates and individuals and also implement regulation in a more proportionate manner. The UK has also been an early adopter of the OECD's BEPS project recommendations which coupled with the impact of Brexit, could have a negative effect on investment activity and hence UK growth.

48. Brexit therefore brings an opportunity for the UK to improve its standing and competitiveness in the international private equity and venture capital industry. The success of the UK as a leading destination for private equity and venture capital firms has been driven by our ability to attract talented individuals who work within the firms themselves as well as the underlying portfolio companies in which the industry invests.

49. With this backdrop in mind, our key recommendations are:
    a. Reducing the complexity and pace of fundamental changes to regulation and tax legislation. The approach to the design of legislation should also be simplified to provide certainty for fund managers and for taxpayers. The Government should also be open to reforming even recent tax changes, given the altered landscape in which the country now needs to operate.

    b. Looking at other ways to improve the competitiveness of UK asset management industry in light of growing competition from other European domiciles which has intensified since June 2016. We welcomed the changes recently implemented for private fund limited partnerships and this has been positively received by the industry. Over time the UK will need to look at other ways to encourage fund

managers to set up and manage funds in the UK whilst balancing the need to ensure mutual recognition and regulatory cooperation with the EU.

50. The UK private equity and venture capital industry requires and encourages cross-border investment with the rest of the EU ("rEU"). Operations, systems and processes are also intrinsically cross border, and need to be for the industry to be cost effective and function efficiently. Over the past three years (2013-2015), 18% (£6.1 billion) of funds raised by the UK industry were from rEU countries. A key priority for our industry is to ensure UK firms still have access to EU investors and vice versa as a loss of access to the European market would substantially impact the ability of the UK industry to raise funds and could reduce the amount of investment available to businesses in both the UK and Europe. As a minimum, European National Private Placement Regimes must remain open to UK firms. This would be alongside third country access for UK firms through a new relationship with the rEU.

Increasing the size of the UK's venture capital industry

51. 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.

52. 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.[11] 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).[12]

53. 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 not only need investors to be able to make follow on investments after their initial investment, but also higher levels of funding in aggregate to meet their growth potential. The disparity 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.[13]

[11] Scale-up UK: Growing Business, Growing our Economy report – available here
[12] British Business Bank, Small Business Finance Markets report – available here (page 56)
[13] Scale-up UK: Growing Business, Growing our Economy report – available here

54. 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

55. 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.

56. **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[14]. 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

57. **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.

58. 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).[15] 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 to aim to raise at least €250m (£220m) before they can attract substantial amounts of institutional investment.

[14] BVCA's 2015 Performance Measurement Survey – available here
[15] European Commission Horizon 2020 report – available here

59. 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.

60. **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.

61. This issue, 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.

62. **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%**

63. 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.

64. 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.

65. 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.

66. 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[16] 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.

67. 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.

68. 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

69. 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.

70. 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.

71. 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

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

investment 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

72. 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.

73. 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.

74. 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.

75. **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.

76. 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.

77. **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.

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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.

78. **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.

79. 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.

80. 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

81. 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.[17]

82. 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.

83. 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

[17] AIC VCT fundraising statistics – available here

example, found them to be, on average, 10 years old.[18] The rules of the Venture Capital Schemes should reflect this fact.

84. 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 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.

85. 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.

86. In the case of Social Investment Tax Relief ("SITR"), the annual and total limits on investment are already below those of the other tax-advantaged venture capital schemes. We believe these limits should be raised. As SITR funds are currently in their initial uptake and only just beginning to build traction with investors, the scale and the size of the investment opportunity is of significant importance to allow the intermediaries and financial advisors to offer these opportunities to their clients.

87. 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.

Corporate governance reform

88. The Green Paper refers to recent work initiated by the Government on corporate governance reform. We have responded to the consultation[19] and met with BEIS to discuss how private equity and venture capital firms improve the corporate governance arrangements of their portfolio companies. Effective governance provides private equity and venture capital backed companies with a strong platform to implement value-building initiatives. As such, private equity and venture capital firms typically seek to introduce and strengthen existing corporate governance arrangements that are in place in the portfolio companies in which they invest. It allows them to effectively monitor and manage their investments from a

[18] British Business Bank, Small Business Finance Markets report – available here (page 57)
[19] BVCA response to green paper on corporate governance reform – available here

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strategic perspective, and educates and supports the investee company with its risk management processes.

89. For the private equity and venture capital firm itself, the benefits of good governance at a portfolio company level are intrinsically linked to its own success. It protects and enhances the value of investments which is important from a reputational perspective, especially as the private equity and venture capital firm will need to fundraise in the future to secure its own longevity. There may also be reporting requirements from the fund's own investors and other regulatory factors to consider (e.g. anti-bribery and corruption). The intention is to implement a governance structure that is self-regulating with an emphasis on creating the right culture that ensures the effectiveness of the arrangements put in place.

90. Whilst we recognise that there have been examples of corporate failures where it appears that corporate governance has not worked in the way it should, it is important to remember that there are also many examples of well-run companies where there are robust and effective governance structures in place which have helped create long-term value. It is therefore key that any reform in this area is both proportionate and balanced so that whilst helping prevent corporate failures, reform designed to deal with the behaviour of a minority of companies does not discourage investment in the UK and disproportionately impact on the competitiveness of UK as a place to locate and to do business. Rather than focusing purely on governance as an end in itself, a more effective approach would be to focus on existing legislation and regulatory regimes that are designed to protect the stakeholders that the Government is specifically concerned about, whether that be employees, suppliers or pension fund beneficiaries.

Long term decision making – the impact of competition law

91. Competition authorities have the ability to rigorously investigate and impose fines on companies that engage in anti-competitive conduct. If the entity that has engaged in anti-competitive conduct is the subsidiary of another company, where appropriate, the liability may be extended up to the ultimate parent company. This strict liability can discourage investment in sectors where there is a risk of anti-competitive behaviour.

92. Competition authorities and the European Commission have in recent years increasingly sought to extend liability to private equity investors, including in circumstances where those investors had no involvement in or the knowledge of anti-competitive behaviour, and indeed may have taken active steps to put in place strict procedures designed to prevent such conduct. It is concerning that liability can be extended to passive investors in a fund even where the unlawful conduct could not reasonably have been detected or prevented, resulting in a strict liability imposed on the private equity investor. Additionally, the liability could be imposed long after a fund has sold a company. Given the finite lifetime of a typical private equity fund, this can create a barrier to investment.

93. Whilst the BVCA believes that liability should extend to parent companies where appropriate, this should not discourage private equity investment unreasonably. Investors should not be held liable where a) they have taken all reasonable steps to prevent anti-competitive behaviour, b) there is no evidence that the investor was complicit in such conduct, and c) such conduct could not have been reasonably detected or prevented.

94. As the UK prepares to leave the EU, there is an opportunity to reduce uncertainty for investors and encourage long-term investment, often in the very industries that would benefit from stronger governance and compliance procedures. Further certainty and encouragement of "best practice" could be provided to investors, including a statutory defence where reasonable procedures have been put in place to prevent anti-competitive behaviour.

Data protection

95. An important element of the conduct of M&A and private investment activities by venture capital and private equity funds, and to a lesser extent fundraising activity itself, is the exchange of data. The General Data Protection Regulation ("GDPR") will take direct effect on 25 May 2018. While Brexit will not have any impact on the implementation of this regulation (and we note the Government has made it clear it is unlikely to step back from the GDPR) it is important that the UK implements the GDPR to maintain the same system as Europe to ensure that it has an "adequate" level of protection for personal data. If the UK does not ensure the level of protection is "adequate" it could harm business activity and the economy as it would prevent the free movement of data, putting the UK in the same category as non-EEA countries such as the US, China and India. This would require burdensome administrative steps to be taken to allow data sharing between the EU and the UK to continue.

Supporting growth of large businesses

96. Whilst the majority of our members' investments are in SMEs, private equity and venture capital firms do invest in large businesses which are some of the largest employers in the UK and significant contributors to GDP. It is therefore important to ensure measures implemented to improve the business environment also apply to investors in large companies. Furthermore our members are incentivised to make long-term decisions that enhance the growth prospects of the companies they have invested in, as this value is realised when the companies are sold or listed on the public markets.

97. To demonstrate the contribution of the private equity industry to the UK economy, each year the BVCA and the Private Equity Reporting Group commissions EY to produce a report[20] on the performance of the largest PE-backed companies in the UK. The report covers 53 companies from a range of sectors, the largest being consumer services, consumer goods, telecommunications and industrials. Key findings from the 2016 report include the following:
    a. The average timeframe of private equity investment in the portfolio companies is 5.8 years, i.e., from initial acquisition to exit. The current portfolio companies have been owned for an average of 4.4 years.
    b. The total equity return on 64 portfolio companies that were exited by private equity investors in the period 2005-15 was well in excess of the comparable public company benchmark, by a factor of 4.3. This significant outperformance is explained in equal measure by the strategic and operational improvements implemented by private equity investors, and the net benefit of additional financial leverage.
    c. Investment at the portfolio companies has grown by 1.6% to 7.6% per annum across a number of measures. In aggregate, private equity investors have used free cash flow and additional third party debt to increase investment in the current portfolio

[20] EY Annual Report on the Performance of Portfolio Companies, IX – available **here**

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by £22.8 billion.

d. Capital productivity growth exceeds public company benchmarks at 6.4% versus 0.1% per annum.
e. Annual growth in labour productivity in the portfolio companies at between 2.0% and 2.4% is on a par with public company and economy-wide benchmarks.
f. Organic employment growth at the portfolio companies has been faster in the last two years, averaging c.3% per annum, consistent with economy-wide benchmarks.
g. The portfolio companies have grown reported revenue at 5.8% per annum and profit at 4.6% per annum; organic revenue and profit growth are both 3.6% per annum.

Pillar 7 – Delivering affordable energy and clean growth

30. How can the Government support businesses in realising cost savings through greater resource and energy efficiency?

Energy efficiency taxation and reporting

98. The Government signalled in the spring 2016 budget that the Carbon Reduction Commitment ("CRC") scheme would be closed by 2019 with lost revenues to be recovered from an increase in rates of the Climate Change Levy ("CCL"). It was announced that a new, simplified energy and carbon reporting framework would be introduced by April 2019. A number of reporting regimes currently run in parallel to the CRC and CCL in the UK, including the Energy Savings Opportunity Scheme, the Climate Change Agreement scheme, the EU Emissions Trading Scheme and narrative reporting requirements required under the Companies Act 2006.

99. Overlapping regimes have created a complicated, arbitrary and disproportionate burden on UK companies. This has been particularly difficult to administer in a private equity context given the failure of these regimes to appropriately address funds and partnership structures. A framework should be developed that retains the energy efficiency incentivisation and revenue raising elements of the current regimes, but reduces the burden for participants by streamlining data collection and reporting requirements. Consultation should take place to ensure common business ownership structures that are not private limited companies are adequately and consistently addressed.

We would be very keen to discuss the contents of this letter further with you and please contact Gurpreet Manku (gmanku@bvca.co.uk) at the BVCA to arrange a meeting.

Yours faithfully,

Tim Hames
BVCA Director General