Department for Business, Energy & Industrial Strategy
1 Victoria Street
London, SW1H 0ET
By email: subsidycontrolconsultation@beis.gov.uk

31 March 2021

Dear Sir, Madam

Re: BVCA response to BEIS consultation on Subsidy Control - Designing a new approach for the UK

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 ("PE/VC") industry in the UK. With a membership of over 700 firms, we represent the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers and investors. Between 2015 and 2019, BVCA members invested over £43bn into nearly 3,230 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private equity and venture capital currently employ 972,000 people in the UK and the majority of the businesses our members invest in are small and medium-sized businesses.

We recognise the immense scale and nature of the challenges facing the Government as a consequence of the COVID-19 pandemic, and the impact this will have on the UK's economy in the near term. The PE/VC industry has continued to invest into UK companies during the crisis[1] and is ready to play a significant role in the UK's economic recovery when it comes. As long-term investors, we will continue to back entrepreneurs and management teams across all the nations and regions in the UK, with a focus on building sustainable businesses that support broader societal and government public policy and economic objectives such as employment and productivity growth, as well as addressing climate change to meet the UK's net zero commitments. PE/VC firms that operate in the UK understand the need to factor in economic uncertainty and invest throughout the economic cycle, including during shocks and downturns, drawing on the deep expertise obtained as the industry has grown substantially in scale over the past few decades.

The BVCA agrees that the UK's subsidy control regime should be clear and based on a set of common-sense principles and guidelines, that avoids burdening public authorities with undue bureaucracy and seeks to maintain their freedom to act swiftly in response to economic emergencies or natural disasters.

We have responded to the questions most relevant for our members based on our experience during the COVID-19 crisis and access to the Government supported loan guarantee schemes, the Coronavirus Business Interruption Loan Scheme ("CBILS") and Coronavirus Large Business Interruption Loan Scheme ("CLBILS"). There is significant scope to improve the UK subsidy control regime and remove obstacles that companies faced accessing these loan guarantee schemes during the crisis. In particular, any alternative to the Undertakings in Difficulty ("UID") definition in the EU State Aid Framework should not be overly restrictive and penalise companies because of their funding structure and approach to investing in their growth.

[1] Invest Europe's H1 2020 report, to which BVCA members also submit data, shows that €11bn was invested into the UK & Ireland in H1 2020, compared to €9.2bn in H1 2019. Our discussions with members confirm that deal activity continued to increase in the rest of 2020, particularly in the tech sector.

Question 1: What type of subsidies are beneficial to the UK economy?

Loan guarantee schemes such as CBILS and CLBILS were extremely welcome during 2020 as the devastating impact of the COVID-19 virus on individuals and the economy had increased sharply. At the start of the lockdown in March 2020, we highlighted to government the urgent need for intervention to support otherwise sound businesses that were facing liquidity and cash flow challenges.

In practice, however, a large number of successful UK businesses with strong prospects of being able to repay any government-backed loans, were unable to utilise CBILS/CLBILS because of a technical definition in the EU's state aid framework. We cover this in detail below and proposed solutions.

Question 3: Do you agree with the Government's objectives for a future subsidy control regime? Are there any other objectives that the Government should consider?

Yes, we agree with the Government's proposed objectives.

Question 17: Should subsidies granted temporarily to address a national or global economic emergency be exempted from the rules on prohibited subsidies and any additional rules set out below?

Yes, as the COVID-19 crisis demonstrated the value of the Government being able to respond swiftly to support businesses that had seen a steep drop in demand for products and services due to the lockdowns.

Question 21: Would more detailed definitions of any of the terms set out in this section, including the definition of "ailing or insolvent enterprises" be useful to ensure a consistent and proportionate approach to compliance? If so, what should these be?

We agree with the feedback in paragraph 75 of the consultation of paper that states that the EU's UID test "has been a particular source of concern for stakeholders who judge that they have been unfairly caught within scope". If a definition of "ailing or insolvent enterprises" is created, then it should not include broad or generic tests that were incorporated in the UID definition.

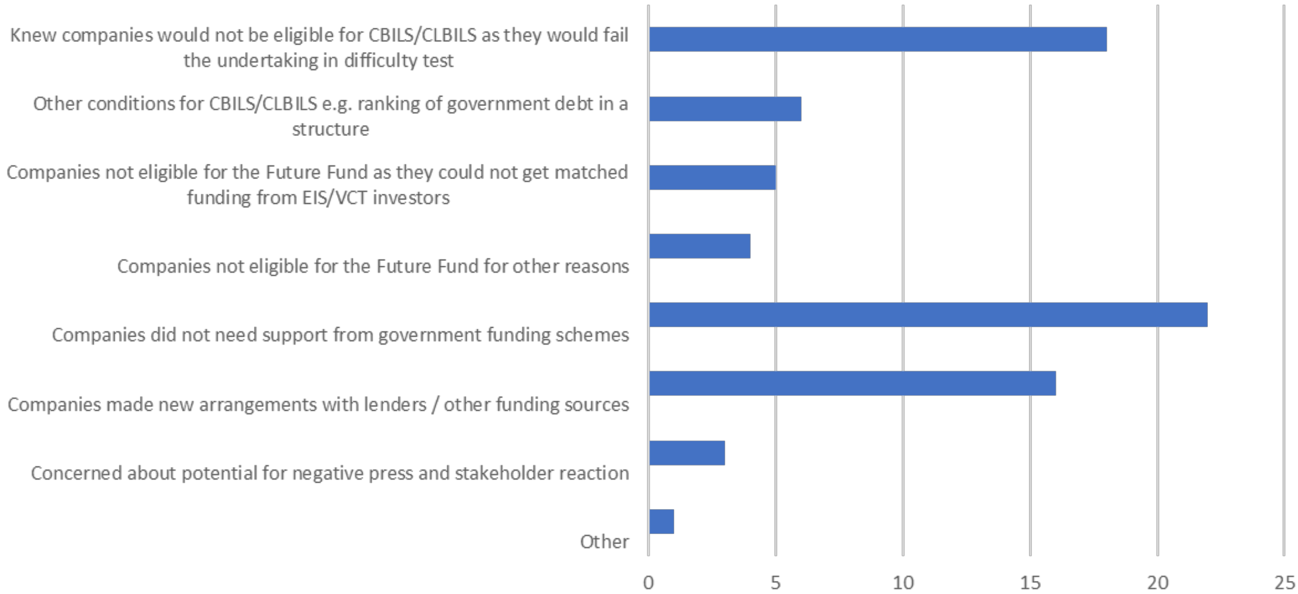
Many private equity or venture capital-backed companies were considered to be UIDs despite not actually being in difficulty. Early stage and growth companies were considered to be UIDs simply because they have borrowed or expended initial share capital to invest and expand, whilst other PE-backed companies were considered to be UIDs due to their performance-focussed management team incentives and financing structures (bank and shareholder loans[2]).

Our Autumn 2020 survey of members[3] showed that not all PE/VC firms needed access to the government schemes, but also that some choose not to apply due to eligibility criteria. 72% of respondents to the survey (33/46 firms) had UK portfolio companies that attempted to access the government funding schemes. The success rates varied though, at 61% for CBILS and 85% for the Future Fund.

[2] Shareholder loans and preference shares are generally treated as debt for accounting purposes but from the perspective of PE investors, these instruments are equity-like in nature.

[3] BVCA feedback and recommendations to government, 11/12/2020 – available here

Several reasons were provided by firms on why they did not seek access to the Government's funding schemes, including the eligibility criteria for the schemes, and the fact that some companies did not need the support.



The EU's UID test justifiably aims to prevent government support for otherwise failing businesses, as in normal circumstances this could distort competition within sectors and within the EU. It is however relevant to note that the General Block Exemption Regulation ("GBER") from which the UID definition is drawn is itself a rare exception to the requirement that any state aid first needs to be notified and approved by the European Commission before being put into effect. Given that context, it is not surprising that a very broad definition of UID is used. Unfortunately, when applied in the context of the COVID-19 crisis, this definition was particularly unhelpful and gave rise to unintended consequences. This is because one limb of the test[4] uses an approach to judging whether a business is in difficulty that is unhelpful when applied to growth companies or those using debt finance, namely whether the company's accumulated losses are equal to or greater than 50% of its subscribed share capital.

Fast-growing companies and successful ones backed by a PE/VC fund will often fall foul of this test, despite having been selected by the fund manager as being businesses with excellent potential. This is because their accumulated losses are greater than their ordinary share capital, due to how the company is funded – via debt rather equity - rather than the companies' operational performance (see the Appendix for further detail).

These businesses were not reasonably "in difficulty", other than because of COVID-19. The financial statements show retained losses and net liabilities, however the directors use more appropriate measures of judging business viability in the circumstances, such as EBITDA growth and relevant loan covenants such as interest cover, and will prepare accounts on a 'going concern' basis. Pre-COVID-19, auditors signed unqualified and unmodified opinions and the banks continued to lend to these businesses. Furthermore, debt used to finance a portfolio company's three to seven-year business plan is typically repaid when a private equity fund exits its investment e.g. on IPO or sale to another buyer.

[4] Article 2(18)(a) GBER

In short, strong, viable companies should not have been excluded from COVID-19 finance packages on the basis of an element of the EU's UID test that incorrectly categorises many companies as having been "in difficulty" prior to the crisis, when in real terms they were not. We believe this issue stems from the fact that GBER is, understandably, not designed to assess whether a healthy business would remain viable but for an extraordinary event such as the pandemic. During the crisis we suggested that the UID test could have been modified by Commission Communication or guidance that allowed banks to place greater emphasis on the specific context, perhaps allowing them to concentrate on other elements of the UID test if the banks were comfortable that it would be appropriate to do so.

Now that the UK is outside of the Transitional Period, addressing the technical issues in the EU state aid framework for the schemes over the longer term, could be a resolution for many businesses in the recovery, especially in the hospitality, leisure and travel sectors.

Our recommendation is removing limb a)/b) of the UID test altogether and placing more emphasis on the remaining parts of the UID test which are more relevant (e.g. insolvency).

We would be very keen to discuss the contents of this letter with you and look forward to hearing from you.

Yours faithfully,

GK Manku

Gurpreet Manku
BVCA, Deputy Director General & Director of Policy

APPENDIX

Detail on the application of the UID test to growth and PE/VC-backed companies

The test requires a company to NOT have accumulated losses exceeding half of its subscribed share capital. Many PE-backed companies fail this test, as it is not well calibrated to how debt finance works. Ordinary shares and share premium are counted as subscribed capital. Preference shares are generally not (some may be classified as equity where the terms permit this), nor are shareholder loans.

At the growth capital end of the market, if a business has recently made losses as its grown and has now just moved into profits it could easily fail the test. Similarly, if a company has fallen back into losses for a period it could also fail the test even if liquidity has been fixed through subscriptions for preference shares or shareholder loans.

In the buyout space, be it small buyouts or large, the vast majority have little chance of passing the test. They structure ordinary shares so management can acquire c.15-20% of the shares and this incentivises the management team to maximise value before exit.

PE funds then provide the remainder of the equity as preference shares which give a modest preferred return to investors. There is no tax benefit from doing so. Additionally, a PE fund will provide shareholder loans. The tax benefit of doing so is also limited due to BEPS requirements on interest deductibility. See more on this in the next section.

In short, the interest on the bank loans and shareholder loans and accrued preference share coupon mean retained losses quickly erode the value of the ordinary shares. This is however usually eliminated on the exit when the value of the ordinary shares increases significantly.

Why debt finance is used in PE/VC-backed businesses

Debt plays an important part in financing private equity and venture capital transactions. In respect of any particular investment and depending on the type of fund and underlying asset class, it may comprise external third party (e.g., bank) debt and / or internal related party (e.g., shareholder) debt.

Bank debt may be used for a number of reasons. Amongst others:

- it can help to finance the acquisition and development of businesses;
- it can improve returns on investments by providing a relatively cheap and stable form of capital; and
- it can increase the spending capacity of a fund and thereby the number and size of investments in the fund's portfolio by leveraging investor commitments.

Internal debt, which can cover both loans from a private equity fund to underlying investee companies and loans within a group of companies owned by a private equity fund, may also be used for a number of reasons:

- it can encourage greater investment in and development of new business lines and geographies;

- it can facilitate a quick and immediate investment in an asset, with a view to a subsequent refinancing with external party debt;

- it can ease the repatriation of cash – the repayment of loans and the payment of interest are not usually subject to the same corporate law constraints as the return of share capital and the payment of dividends;

- it can provide comfort and certainty in an insolvency scenario – the rights of loan creditors are generally more clearly defined and rank ahead of shareholders; and

- it can create efficiencies which investors find attractive and therefore encourage them to invest further capital.

It will be clear from the list above that the reasons for using debt finance in a private equity and venture capital context are not all tax-related. The fact that interest is generally deductible does mean that in some circumstances the cost of capital can be reduced and the returns for investors improved, increasing and encouraging investment in businesses – which we believe has a very important role in promoting growth in the UK and global economy.