bvca The voice of long-term investment

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1. Introduction and industry update

The BVCA is the representative body for private equity and venture capital in the UK. Our 450 members cover the whole investment spectrum, from venture capital firms investing into high growth technology start-ups, to the largest global buyout funds turning around and growing mature companies.

Activity data: PE backed buy-outs

In common with the rest of the financial sector, 2009 was a particularly tough year for the industry. 2008 saw a drop off in activity, but fundraising and investment figures held quite strongly, with £20bn invested and £23bn raised by BVCA members. Comprehensive data are not yet available in these areas for 2009, but our annual reports due out in a few months are expected to show a significant drop off in both money invested and raised.

Data from CMBOR shows in the year that to 31 December 2009 the value of UK private equity buyouts dropped to its lowest level since 1995. At £4.7bn, activity was roughly 15% of 2007 levels. The number – as well as the value - of deals also decreased significantly. There were 117 private equity buyouts in 2009, nearly half as many as in 2008 and roughly a third of the number of deals two years ago[[1]].

Returns

Whilst short term conclusions can be drawn from current mark-to-market-valuations, private equity and venture capital are long term asset classes, which over the last ten years has produced an average IRR of 15.4% (16.4% since inception), compared with just 1.2% from the FTSE All-share. These are long term returns for investors such as pension funds, who account for almost half the money the industry raises.

The private equity business model and its wider benefits

The private equity business model has adapted to the new climate, with equity in those deals which did happen now accounting for 60% in 2009, as opposed to 40% in 2008. We expect his trend to continue with some firms aiming to move down the deal spectrum to focus more on growth capital or smaller buyouts.

Alongside this, a study by Ernst & Young (Annual Report on the Performance of Portfolio Companies) found that in 2008/09, labour productivity in companies owned by private equity grew by 8% per annum, compared with the UK economy as a whole which has been struggling to exceed an annual increase of 1%. Similar out-performance is emerging in capital productivity. Such a differential can only be the consequence of superior strategic and operational management techniques and the underlying strength of the private equity business model.

[[1]] CMBOR/Barclays Private Equity. NB these data are separate from the annual Report on Investment Activity, published by the BVCA later in the year.

2. EU AIFM Directive

The Alternative Investment Fund Managers (AIFM) Directive remains a priority for the BVCA, as we know it does for the Government. We are grateful for the focus and attention which HM Treasury and the FSA have given this legislation and are hopeful this will lead to substantive progress in the crucial next few months.

We do not offer a detailed analysis of negotiations in our submission here, as we are in constant contact with officials on the many, continually moving key issues.

Whilst some encouraging progress appears to have been made in some areas, critical areas of concern remain over the third country regime, depositaries, portfolio company disclosure and overall scope of the regulation. As a recent House of Lords Committee report noted, unless the legislation is consistent with a global regulatory approach, it will "seriously damage EU and UK economies". The Bank of England's Financial Markets Committee said it is "riddled with ambiguities".

The Spanish presidency appears committed to a highly ambitious timetable in seeking to reach an agreement on the text within the coming weeks. In seeking a quicker deal we urge government to ensure we do not reach unsatisfactory compromises on key issues.

The fact that over 2,000 amendments have been tabled to the ECON committee's report in the European Parliament demonstrates the strength of feeling on these issues and that there is still a way to go on reaching agreement. We would much rather see greater time taken to arrive at a workable directive than a quick agreement on a text which retains significant areas of difficulty.

One additional concern is the timing of a UK General Election and the potential impact that may have on the government's own ability to continue discussions during a vital phase for the directive. Our concern, if the UK Parliament has been dissolved for a general election and/or the new Parliament has just begun to sit, is that this could hinder the UK government's ability to take key political decisions.

3. Update on Walker framework for transparency and disclosure

The transparency and disclosure regime drawn up by Sir David Walker in 2007 is now in its third year of operation. The scheme has been operating successfully for two years and continues to be fully supported by the UK private equity industry.

Conformity with the Walker Guidelines (Guidelines) is monitored by the Guidelines Monitoring Group (GMG) which is chaired by Sir Michael Rake. In the Spring of 2009, the GMG recommended that the definition of 'portfolio company' used in the Guidelines to determine portfolio companies that are required to conform should be expanded. Under the amended criteria, instead of requiring the portfolio company to have a minimum of both: 50% UK revenues AND 1,000 UK employees, the revised criteria require a minimum of either: 50% UK revenue OR 1,000 UK employees.

As a consequence of this change, the number of required portfolio companies increased from 27 to 47, bringing the total number of companies covered by the Guidelines (including volunteers) to 61. All portfolio companies meeting the expanded criteria (and their private equity owners) signed up to the Guidelines.

The GMG has decided that the portfolio company threshold (£500m enterprise value for all secondary and other non-market transactions; £300m for public to private transactions) should be lowered to £350m and £210m respectively. The BVCA has accepted this recommendation and is in the process of implementing this change.

4. Venture capital & small companies

The Government has long recognized the benefits of venture capital, and its role in encouraging innovation, entrepreneurship, turning scientific ideas in to businesses and helping small businesses grow and develop. We are very encouraged by recent Government moves in this area (see below) but feel there are is one area in which the Government could go further in the forthcoming Budget without imposing additional cost.

UK Innovation Investment Fund

The UKIIF has the potential to see high quality but struggling venture-backed companies through the downturn as well as to play a longer term catalytic role in encouraging institutional and other investors to allocate more to venture as an asset class.

The BVCA has long been an advocate for this scheme and we have been encouraged by the progress made since the announcement in June 2009. The additional capital raised by the two fund of funds managers is an impressive achievement in the current climate and we hope that the UKIIF framework is seen as a template for future interventions in this area.

The focus now must be on ensuring that the capital raised is invested speedily so that the young innovative companies at which the scheme is aimed receive the financing they need.

Other measures:

Creating a gateway for existing small company schemes

The BVCA has (in recent submissions over a number of years) proposed a series of amendments to existing small company interventions, which we believe could make a significant difference to both the effectiveness of these schemes as well as the environment for venture capital in the UK. These include alterations to the Enterprise Management Incentive, the Enterprise Investment Scheme and R&D Tax Credit as well as Venture Capital Trusts.

Given current pressures on public spending however, we realise that the costs of introducing such measures are unlikely to be practicable. A more immediate and feasible suggestion would be to bring the existing interventions together 'under one roof'.

Knowledge of and access to the whole range of small company schemes could certainly be better. A 'one stop shop' which acted as a gateway to schemes, as well as a repository for data on them, could be highly beneficial and have the potential to make a difference in the near term.

We encourage Government to give serious consideration to this idea in the lead up to the Budget Statement.

5. Encouraging low carbon investment

The BVCA's Energy, Environment and Technology Board (EETB) consists of UK-based fund managers that invest in low carbon, renewable and sustainable technologies, from early stage venture capital to infrastructure investors deploying proven clean power generation technologies. Collectively they have over £10 billion in funds under management; of which over £700 million has been invested in UK companies, saving an estimated 4.2 million tonnes of CO_2 p.a.

The EETB believes that the UK can be a world leader in developing, deploying and financing green technologies. Private equity will play a material part in providing the capital and backing the innovative companies that will realise that goal. The EETB has the following suggestions to encourage investment in to low carbon technologies and would be happy to discuss them in more detail with officials.

Regulatory certainty and stability

A low carbon economy will take years, if not decades, to realise. Attracting capital requires long term regulatory certainty and stability, which can best be achieved by:

- Maintaining key policies such as the Renewables Obligation (RO) without material change or further review.
- Applying robust sustainability standards for biofuels while maintaining or increasing existing, post Gallagher targets for biofuels in the UK.
- Pledging no change to planning appeals or reviews for projects in the system following the next election.
- Producing clear, consistent planning guidelines and time frames.
- Keeping local rates local for five years.

Spur capital formation

A low carbon economy will be capital intensive. Capital formation can be enhanced by:

- Granting Real Estate Investment Trust Status (REITS) to renewable energy projects.
- Supporting changes to Venture Capital Trusts, which will facilitate greater local participation in cleantech and renewable energy projects.
- Ensuring substantial UKIIF participation in UK cleantech private equity/venture capital funds.

Smart grid and electric vehicle charging

The smart grid is one of the keys to a low carbon future; it should be accelerated by:

- Mandating the roll-out of smart meters for gas, electricity and water to all consumers over 5 years rather than 10 years.
- Share the cost of grid connections across all users for large renewable energy infrastructure projects.
- Developing a national network of standardised recharging points for electric cars.

Develop deliverable short, mid and long term targets

There are solutions available today for a low carbon Britain; others do not yet exist. We suggest that policy goals reflect this through:

- Maximising deployment of technologies that are available such as biomass, energy efficiency, onshore and offshore wind renewables and existing sustainable biofuels.
- Paving the way for decentralised and more efficient energy provision through a smart and extended grid.
- Supporting earlier stage but highly capital intensive renewable energy and other clean technologies in development such as tidal, wave and carbon capture & storage (CCS), so that they can play a role from the next decade onwards.
- Avoiding unachievable but potentially costly targets such as 50% biogas penetration.

6. Taxation

In order to ensure the UK preserves and reinforces its position as the centre for European private equity and venture capital, the UK tax system should: (i) be stable; (ii) give certainty to taxpayers; (iii) offer simplicity wherever possible; and (iv)have internationally competitive tax rates which encourage highly skilled people and businesses to locate and invest in the UK.

In recent years the UK has not performed well on these measures. Increases in Income Tax and changes to the capital gains regime have had a negative impact on the attractiveness of the UK as a place to do business, in respect of competitiveness and stability in particular. We also have the most complicated tax system in Europe.

As the UK emerges from recession, it is imperative that the tax system supports and facilitates the recovery and does not put in place obstacles to it. We outline below specific areas where we see threats to this objective.

Capital Gains Tax

Any further changes to the CGT rules, and in particular any increase in the headline rate of CGT would be deeply damaging. A low, stable and competitive capital gains regime is vital for private equity, venture capital and the economy as a whole, as it:

- **Encourages enterprise, investment and entrepreneurialism**

A stable tax regime coupled with a low rate of capital gains tax spurs economic activity and encourages risk capital investment, and academic evidence supports this. In the late 90s, Paul Gompers and Josh Lerner found empirical support for the idea that lower capital gains taxes boost VC fund raising[2]. Decreases in capital gains tax in the US had a "positive and important impact on commitments to new VC funds", and lower rates "increased the demand for VC as more workers are encouraged to become entrepreneurs".

Cuts in the US capital gains rate in the 90s were seen to have had a particularly strong effect on the amount of venture capital supplied by tax exempt investors, who are not affected directly by the change. This suggests that the primary mechanism by which capital gains tax cuts affect venture fund raising is by increasing the demand of entrepreneurs for capital - one of the biggest issues facing the UK. The limited research done in Europe suggests similarly that entrepreneurial activity is sensitive to capital gains tax rates.

Other academic studies show that the effect of CGT reductions in the US has been to increase entrepreneurial activity and the demand for venture capital financing. There is no evidence that tax avoidance has significantly increased or that the yields of income tax have been adversely affected.

There is evidence that expected changes in CGT in the US have contributed to increases in share prices and reduced the cost of capital for enterprises. CGT changes are also very likely to have favourably affected the demand for high growth stocks, particularly from private investors, and market liquidity for smaller company shares[3].

- **Is effective at increasing economic activity and raising revenue**

Capital gains is a voluntary tax and people are incentivised to sell an asset when rates are low, stable and competitive. This is particularly true for private equity and its long term investment model. The

[2] *What Drives Venture Capital Funding*?: Gompers and Lerner, 1997
[3] *Capital gains tax and enterprise: The US Experience,* Bannock Consulting

introduction of a reduced rate of CGT has proven to be good both for stimulating economic activity and for tax receipts. UK CGT receipts have risen every year since the 2 year 10% taper was introduced in 2002, achieving the government's aims to "encourage entrepreneurial investment and to reward risk taking".

The introduction of the 18% headline rate in 2007 increased tax for some, but actually reduced rates for many. The removal of both the taper and the distinction between business and non-business assets meant that rates on gains were reduced from 40% to an 18% rate from day one on all assets. The retention of the 10% rate via entrepreneurs' relief also helped keep CGT low, and the overall impact again was an increase in receipts.

CGT receipts[4]**:** 2002/03: £1.6bn
2003/04: £2.2bn
2004/05: £2.3bn
2005/06: £3.0bn
2006/07: £3.8bn
2007/08: £5.3bn
2008/09: £7.8bn

The increase in activity demonstrated by the revenue rise will also have led to an increase in economic activity elsewhere (through, for example, advisory and transaction services), all of which benefit the wider economy.

- **Maintains the UK's competitive position**

The UK is currently around mid table in the league of international CGT rates (7th out of the 16 major international competitors listed below). Even a small increase in the current rate however would push the UK down several places. An increase of 3%, for example, would move us to 11 out of 16, and anything beyond that would leave the UK near the bottom of the international league table.

Headline Capital Gains Tax rates for individuals[5]

Ranking	Country	Rate	
1	Netherlands	0%	
=	Hong Kong	0%	
=	Switzerland	0%	
4	Italy	12.5%	
5	USA	15%	
=	Brazil	15%	
7	**UK**	**18%**	*
8	China	20%	
=	Japan	20%	
10	India	20.6%	
11	Spain	21%	
12	Canada	22%[6]	
13	Ireland	25%	
=	Sweden	25%	
15	Germany	26.4%	
16	France	30%[7]	

[4] HM Treasury, Budget and Pre-Budget Reports 2002-2009.
[5] Source: Ernst & Young. Where relevant, a share holding of at least 12 months is assumed.
[6] Average figure, dependent on province: ranges from 19.5% - 24.13%.

Any increase in CGT rates has the potential to hinder the recovery
As many – including government ministers – have noted, the UK's economic recovery is fragile and care must be taken to ensure that we do not enter into a 'double dip' recession.

The private equity and venture capital industry is one of the very few sources of capital available. Some estimates suggest that globally the industry has up to $1trillion of dry powder at its disposal[8]. The investment environment needs therefore to be as attractive as possible to encourage as much of that as possible to be deployed in the UK.

The industry also has a proven track record over a number of economic cycles of increasing productivity and producing strong returns for investors, many of whom have been pension funds. It is also an active owner of companies, structured in a way that aligns the interests of managers with investors. In contrast to many other areas in financial markets, the model of remuneration is entirely aligned to long-term success, with no rewards for failure.

It can help in all areas of the economy: it has expertise in supporting new business start-ups and university spin-outs; rescuing companies from administration; in helping mid-sized businesses to grow and expand into new markets; and in helping to re-energise larger businesses and make them more productive.

Other issues

In addition, there are three current issues which the BVCA would like to highlight.

1. **Bank Payroll Tax**
   The initial drafting around the proposals on Bank Payroll Tax in December's Pre-Budget Statement would have caught many private equity and venture capital firms. Given the intended target of the measure, this would have been wholly inappropriate. The BVCA worked closely with HMRC to ensure private equity firms were not caught by the legislation. Those discussions appear to have brought about a solution which would ensure the vast majority of private equity firms are not captured. We look forward to confirmation of this when the legislation is published.

   Private equity funds which are owned by banks remain a sticking point however, and we continue to work with HMRC officials to find a way through this.

2. **Debt Buybacks**
   The Government announced last year measures to stop companies from buying back their debt in a way which does not trigger an immediate tax charge (based on the profit on the debt) unless the company is, in essence, put into insolvency. There is already evidence that this change has made it harder and more complicated for struggling companies to restructure their balance sheets; a development which is compounded by the current economic climate.

   This announcement is in sharp contrast to the US where provisions have recently been introduced to help companies in this position by making it easier for them to buy back their own debt without immediate tax penalties and it is unfortunate that the UK Government has chosen to do the opposite and make their position more difficult.

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[7] 18% capital gains plus 12% social security.
[8] Preqin

The BVCA has made little progress with HMRC on suggesting how the tax treatment of such buybacks could be amended both to protect the position of vulnerable companies whilst preserving the Government's ability to tax profits but at a later date when the loan would normally be repaid.

3. Late Paid Interest

In our Pre-Budget Report submission we referred to the anomaly arising on the interaction of the late paid interest rules with the Worldwide Debt Cap rules. The impact of such an interaction is that, in many cases, corporates whose tax relief is delayed under the late interest rules will have the relief denied under the Worldwide Debt Cap.

The BVCA has since corresponded and met with HMRC on this seemingly unintended and unfair outcome. In our representations we included suggestions for how the law could be amended. We have been pleased to see a very high level of engagement by HMRC on the issue. However we have yet to see proposals for rectifying the issue which is a high priority for our members.