Financing Growth in Innovative Firms
HM Treasury (2 Orange)
1 Horse Guards Road
London
SW1A 2HQ

By email: financing.growth@hmtreasury.gsi.gov.uk

22 September 2017

Dear Sirs,

Re: Financing Growth in Innovative Companies – BVCA response to the consultation paper

I am writing on behalf of the British Private Equity & 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 650 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.

We welcome the Patient Capital Review and the opportunity to comment on the questions posed in the consultation paper. We support the Government's proposal to establish a new National Investment Fund within the British Business Bank and believe this should provide additional funding to its current programmes. Increasing the number of larger venture and growth capital funds in the UK by attracting additional institutional investment should be the key aim of the fund. This will improve the industry's ability to support companies over the long-term by taking meaningful stakes in businesses over multiple funding rounds, including the larger, later stage funding rounds associated with scaling up a business.

We would also encourage the Government to give its full support to the tax-advantaged venture capital schemes (EIS, SEIS and VCTs) and make improvements within the current EU State Aid Framework. Significant sums have been raised from retail investors through the schemes, and they have played an important role in providing early stage funding for companies. SEIS, EIS, VCTs are well-established programmes that resonate well with investors and investees and this is a significant achievement after many years of government support.

Our detailed feedback is set out in the attached response. We have previously met with representatives from HM Treasury to discuss the work of our industry and would be delighted to meet you again to discuss this response in further detail.

Yours faithfully,

Tim Hames
BVCA Director General

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BVCA Response to the Consultation Paper on Financing Growth in Innovative Firms

UK industry and ecosystem

1. The impact of private equity and venture capital on the UK economy was set out in our response to the Government's Industrial Strategy Green Paper in April 2017[1]. This response covers Government interventions and schemes that encourage investment in UK businesses that are new, innovative and scaling up.

2. Recent independent research[2] 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 GDP, and supports 326,000 jobs.

3. 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.

4. The UK has a dynamic and professional venture capital and private equity ecosystem which is smaller than the US, but it is growing and continues to be the second biggest hub worldwide. The right policy interventions will strengthen and bolster the scale of the UK's venture, growth capital and lower mid-market funds industry and this includes increasing the funding available to the BBB to invest in funds through the creation of a National Investment Fund. At the same time, we are supportive of efforts by the Government to maintain an ongoing relationship with the EIF, given its significant investment in UK funds.

5. To ensure there is diversity in funding sources for UK businesses, we would also encourage the Government to give its full support to the tax-advantaged venture capital schemes (EIS, SEIS and VCTs). Significant sums have been raised from retail investors through the schemes, and they have played an important role in providing a continuum of early stage funding for companies from angel investing through to venture capital.

6. The Government, however, needs to consider the other factors that have made the UK venture capital and private equity industry successful as we navigate the process of leaving the EU and the uncertainty this brings. The UK's funds industry must be globally competitive and the Government can create the right regulatory, tax and fiscal incentives to ensure the UK remains an attractive place to set up a fund manager, invest and conduct asset management activities. SEIS, EIS and VCTs are important development funding to build the generation of growth companies that are moving into the next phase of larger scale up capital. A population of attractive investee companies is essential in order to raise the larger funds the Government is aspiring to.

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[1] BVCA response to the Industrial Strategy Green Paper, available here

[2] The contribution to the UK economy of firms using venture capital and business angel finance (Oxford Economics & BVCA, available here)

7. The UK also needs to continue to attract the best international talent at both a firm and portfolio company level. The following areas need to be considered when creating the right infrastructure and ecosystem for the UK's venture capital and private equity funds industry, particularly in light of growing competition from other EU and international jurisdictions as a result of Brexit :

- A stable legal and tax environment so that investors have the certainty they need to make investments over the longer term. This requires 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, particularly those aimed at incentivising individuals to invest capital for the long term.

- The FCA has a strong reputation and the consultation paper notes recent initiatives such as Project Innovate; the benefits of this initiative should be rolled out to the broader funds industry. A regulator with a streamlined and efficient authorisation process will provide the speed, clarity and certainty firms needs to set up their fund management businesses in the UK. The same principle applies for HMRC's advance assurance process for tax-advantaged venture capital schemes.

- The UK implemented a private fund limited partnership regime in April 2017 which has helped to improve the competitiveness of UK fund structures in light of intense competition from other countries. However the Government needs to conclude its work on its broader review of limited partnerships in a manner that does not lead to undue administrative burdens that negate the attractiveness and benefits of the new regime.

- The Government will also need to ensure that any new migration system considers UK economic and business priorities and seeks industry input in setting immigration priorities that reflect the skills needed. Operationally, the visa process will need to be efficient to ensure the UK remains an attractive hub for business post-Brexit.

Analysis of the market

8. The BVCA report on investment activity and performance measurement survey[3] provide some further analysis that demonstrate that changes are occurring to address the negative feedback loop discussed in the consultation paper, especially in terms of performance. Our data shows that returns (IRRs) for VC funds are improving (see table 1).

[3] BVCA's 2016 Performance Measurement Survey – available here

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Table 1. Venture capital returns in 2015/16

	Annual Return		3-year return (%p.a.)		5-year return (% p.a.)		10-year return (% p.a.)	
	2015	**2016**	2015	**2016**	2015	**2016**	2015	**2016**
VC – pre-2002 vintage funds	0.4	**10.0**	19.5	**11.6**	4.3	**6.0**	-0.3	**0.6**
VC – 2002 vintage funds onwards	10.9	**14.2**	15.5	**12.5**	10.4	**12.1**	7.9	**8.6**
FTSE All-Share	1.0	**16.8**	7.3	**6.1**	6.0	**10.1**	5.6	**5.6**

9. There is also more institutional appetite from UK pension funds. The amounts raised from UK pension funds by BVCA members in 2016 was the highest since the financial crisis at £839mn and 14% of total fundraising (2015: 6%). Pension funds (including those based overseas) represent a third of all funds raised in 2016 (2015: 16%). Whilst fundraising dropped significantly in 2016, nearly halving from 2015 (£6.1bn), funding from UK sources was consistent at £2.68bn (2015: £2.61bn); this is a much higher proportion of the total of funds raised at 44% (2015: 22%). This was followed by US sources at 25% (2015: 17%) and the rest of Europe at 17% (2015: 32%).

10. Global investment by BVCA members in 2016 was at its highest level since the financial crisis, at £21.4bn. 33% of this investment by amount was in the UK (2015: 35%) but on a quarterly basis, the amount invested in the UK fell from over £2bn in Q1 and Q2 to £1.3bn in Q3 and £1.5bn in Q4 which could be attributed to the vote to leave the EU. In 2016, divestments were at record levels since the BVCA began collecting statistics (£29bn).

11. While London and the South East continue to dominate the investment landscape, there has been a notable increase across the rest of the UK (see table 2).

Table 2. Regional breakdown of venture capital and private equity investment[4]

Region	Number of companies			Amount invested (£mn)			% of amount invested		
	2016	**2015**	**2014**	**2016**	**2015**	**2014**	**2016**	**2015**	**2014**
London	204	208	173	2,723	2,459	2,145	38	41	45
South East	115	114	114	686	812	578	10	14	12
South West	48	47	50	508	259	233	7	4	5
East of England	34	36	29	781	366	48	11	6	1
West Midlands	41	66	57	1,185	288	336	17	5	7
East Midlands	23	26	23	294	359	249	4	6	5
Yorkshire & The Humber	38	47	53	150	770	397	2	13	8
North West	78	91	75	539	424	448	8	7	10
North East	19	27	30	70	38	12	1	1	0
Scotland	58	72	61	131	138	206	2	2	4
Wales	50	40	47	49	55	51	1	1	1
Northern Ireland	20	21	16	2	20	16	0	0	0
Total	**728**	**795**	**728**	**7,119**	**5,990**	**4,720**	**100**	**100**	**100**

[4] BVCA's 2016 Report on Investment Activity – available here

Q1: Do a material number of firms in the UK lack the long-term finance that they need to scale up successfully?

Q2: Where is the gap most acute by type of firm, stage of firm development and amount invested?

12. As the Government's consultation paper correctly identifies, there has been a significant increase in the number of early stage deals and the amounts invested in early stage companies over the past five years. There have been concerns however about seed funding, particularly where funds have utilised EU schemes (this fall is yet to show in official figures). There is also a significant gap when it comes to later stage companies that are attempting to scale up.

13. Recent comparative studies of the US and UK venture capital markets have evidenced the relative paucity of later stage funding for UK companies, with UK companies receiving later stage funding less frequently than their US counterparts. Those UK firms that do succeed in raising later stage funding nevertheless receive less than their US counterparts. BVCA research has shown that while the average amount invested in later stage VC has fallen, this has increased for growth capital (see table 3).

Table 3. UK investment by Financing Stage[5]

Financing Stage	Average amount invested £000s		
	2016	**2015**	**2014**
Seed	299.8	845.7	260.4
Start-up	935.0	1,087.5	352.3
Early Stage	772.4	701.6	465.7
Later Stage VC	**1,065.9**	**2,023.9**	**2,976.6**
Total Early Stage	788.2	1,032.2	914.5
Expansion/Growth Capital	**5,997.2**	**3,183.4**	**3,729.7**

14. Research by the British Business Bank shows 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).[6] A 2016 report published by the Scale Up Institute and Barclays found that, on average, UK companies raised 15% less in Series D rounds and 23% less in Series E than their US counterparts.[7] This is reflected by the smaller number of UK investors that follow on their initial investment through multiple funding rounds. only 15% of UK companies' investors invested for three rounds or more, compared with 25% of US companies' investors.

15. There is a strong connection between the scale of the UK venture capital industry and the UK's relatively weaker performance on later stage funding. This means that only larger funds, with sufficient capital to build an appropriately diversified portfolio of investments, will be able to participate in a significant number of larger, later stage funding rounds. However, the

[5] BVCA's 2016 Report on Investment Activity – available here

[6] British Business Bank, Small Business Finance Markets report – available here

[7] Scale-up UK: Growing Business, Growing our Economy report – available here

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UK funds are typically smaller than their US counterparts, with the median US venture fund being almost 30% larger than the UK's.[8] Key to bridging the gap for later stage funding will be building scale in the UK venture capital industry.

16. We are not convinced that patient capital is, as a matter of definition, capital provided to innovative, disruptive firms, as suggested in the consultation paper. Both firms in new, high-tech, disruptive sectors, and companies engaged in more traditional activities have difficulty raising larger later stage funding rounds. Furthermore, there are many high growth companies in a wide variety of sectors that can contribute to economic and employment growth in the UK. We would encourage the Government to think about the patient capital gap as being more closely related to size and the ability to scale up than any particular sector: UK fund managers find it more difficult to stay invested over multiple rounds, into the larger, later stage funding rounds, because they lack sufficient scale.

Q3: Have we correctly identified the UK's current strengths in patient capital?

17. The consultation paper is correct to partly attribute the UK's strength in early stage funding to the tax-advantaged venture capital schemes. However, the paper only takes note of EIS and SEIS. We would also emphasise the value of Venture Capital Trusts, particularly in the context of patient capital, as it is non-cyclical and there is greater certainty over follow up investment. These are areas where scale counts.

18. While less money is raised through VCTs than EIS, VCTs are better suited to providing longer-term capital as a result of being structured as closed-ended evergreen listed funds. This type of structure has two advantages. First, it provides investors with access to liquidity without the need for the fund manager to sell the underlying assets, through the secondary sale of shares in the VCT on a public market. Second, it enables raised funds to be reinvested in eligible companies after assets are sold.

Q4: In what order would you prioritise the UK's weaknesses in patient capital?

19. The BVCA believes that the key weakness in the UK's market for patient capital at present is the fact that fewer UK firms receive follow on investment than their US counterparts, and those that do, typically receive less. The lack of availability and visibility of expansion finance constrains the growth of UK companies as the focus shifts to survival rather than further investment, which has clear implications for the UK economy in terms of jobs, growth and productivity. It also reduces returns for their venture capital backers, making the asset class less attractive to investors.

20. The BVCA believes that the dominance of London and the South East in terms of attracting patient capital in relation to the rest of the country is an area that requires further review. However, as the consultation paper notes, the extent of London's dominance differs when looking at different sectors and deal sizes. Further work is required on the extent and the drivers of regional imbalances in investment before an appropriate policy response can be determined.

[8] Scale-up UK: Growing Business, Growing our Economy report – available here

21. A deeper market for venture debt could help address some of the weaknesses the consultation paper identifies in the patient capital market. First, increased use of venture debt would make further funds available to be used for follow on investment or additional diversification. Second, an increased use of venture debt could improve returns for venture capital funds by reducing dilution, which would make venture funds more attractive to institutional investors.

22. Healthy public markets are also key to the functioning of the broader ecosystem for financing high growth companies. However, we note that even in the US, acquisitions account for the vast majority of exits from venture capital backed companies.[9]

23. The BVCA agrees with the consultation paper's conclusion that in order for the venture capital market to function effectively, it is not sufficient to simply increase the level of overall funding for the industry. Funds raised must also be allocated efficiently within the asset class.

Q5: What are the main root causes holding back effective deployment of and demand for patient capital?

24. We believe this means the recommendations from the review should aim to deepen the UK's capital markets for patient capital by attracting additional institutional investment, with a view to increasing the number of large venture and growth capital funds in the UK. In our response to the Government's Green Paper on industrial strategy, we argued that the UK venture capital markets suffered from fragmentation. 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, with over 60% of UK funds falling below $100m in size compared to less than 50% in the US[10].

25. Smaller funds will be less able to hold an appropriately diversified portfolio while also providing sufficient follow on funding to enable their portfolio companies to maximise their growth potential. They will also have less capacity to provide non-financial support to companies in their portfolios. Similarly, smaller funds are less able to raise large amounts from institutional investors because ticket sizes for smaller funds are typically below the minimum level at which it is viable for larger institutional investors to commit.

26. Increasing the number of large funds would therefore help overcome some of the problems identified by the consultation paper including poor returns, early exits and thin capital markets. However, it is likely that government intervention will be required, at least in the first instance, in order to achieve this. This reflects the fact that there is a 'bootstrapping' problem involved in generating larger venture capital funds against the back drop of thin capital markets—both because there will be less money available for investment, and because in a difficult fundraising environment, managers will be under pressure to sell their portfolio companies early in order to demonstrate returns prior to raising subsequent funds.

[9] Pitchbook/NVCA Venture Monitor Q2 2017 – available here
[10] Scale-up UK: Growing Business, Growing our Economy report – available here

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Q6: What are the main barriers holding back effective supply of patient capital by major investors?

27. **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 table 1 above[11]. 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.

28. **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 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.

29. 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).[12] Furthermore, according to the study, institutional investors will typically invest no more than 10% of a fund's total value. This suggests that, as a bare minimum, funds need to aim to raise at least €250m (£220mn) before they can attract substantial amounts of institutional investment.

30. 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.

31. **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.

32. 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.

33. **Regulatory Barriers** – 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 their fee structures. This is an area which will

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[11] BVCA's 2016 Performance Measurement Survey – available here
[12] European Commission Horizon 2020 report – available here

need to be reviewed by the Government if it wants to increase the amount of investment from Defined Contribution pension schemes.

34. Insurers are also significant investors, providing 5% of funds raised by BVCA members in 2016. Again the proportion from UK insurers was low at just 1%.[13] 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.

Q7: Which programmes (investment programmes, tax reliefs and tax-incentivized investment schemes) have most effectively supported the investment of patient capital to date?

35. EIS and VCTs have played a key role in improving the availability of finance to early stage companies. VCTs in particular are able to provide patient capital as they are, for the most part, structured as closed-ended evergreen listed funds. This provides investors with access to liquidity without the need for the fund manager to sell the underlying assets, enabling the funds to remain invested in companies over the long-term.

36. As closed-ended evergreen funds, VCTs have the advantage from a cost effectiveness standpoint that the proceeds of asset sales are recycled within the fund and reinvested into additional companies. This means that the 30% income tax relief draws in an initial capital sum that can grow and be reinvested multiple times by the VCT manager in a number of eligible undertakings.

37. Analysis from the Venture Capital Trust Association, which has examined VCT deals from November 2015 to September 2017, shows an increasing level of investment in small companies, with 82% of investments made in companies with less that £3mn revenue (including any follow-ons in to these companies) with an average investment amount of £1.9mn.[14] Research from the Association of Investment Companies (AIC) demonstrates the economic impact from businesses currently receiving VCT backing, which employ 50,000 staff and have created 27,000 jobs since their investment was received. [15]

38. We would also highlight the EIS and SEIS programmes, which invest in the very early years of a small businesses growth cycle and a number levels in the growth and development market. The combination of EIS, SEIS and VCTs show that many levels of the patient capital ecosystem are already in existence. SEIS allows for very early stage, EIS provides for a further advance in maturity and VCTs for further scale up. The complimentary nature of these schemes must be preserved as they all serve an essential role in the development of early stage innovative companies and any reduction in support would be very damaging for the UK's wider entrepreneurial ecosystem.

39. Of the public investment programmes, the European Investment Fund's investment programme has had the biggest impact on the UK market. This is largely a function of its scale,

[13] BVCA Report on Investment Activity in 2016 – available here
[14] VCT Investment Survey from the Venture Capital Trust Association – see Appendix 1
[15] Association of Investment Companies (AIC) VCT Investment Review 2017 – available here

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and the stage at which it invests, frequently providing cornerstone funding for managers. The BVCA recently surveyed our members who have received EIF investment and 19 firms have responded. 30% of respondents said that without EIF investment, they would have struggled to reach a first close. A further 47% said that without the EIF they would have raised a smaller amount. Only 12% of respondents said there would have been little or no impact had the EIF not invested.

40. We are already witnessing an uncertain outlook for the UK venture capital industry,[16] and as the UK leaves the European Union, it is essential that this funding is either maintained or replaced by a domestic alternative.

Q8: Are there areas where the cost effectiveness of current tax reliefs could be improved, for example reducing lower risk 'capital preservation' investments in the venture capital schemes?

41. The BVCA has long called for extensions to EIS and VCTs as they will lead to considerably more investment in UK SMEs. We recognise that HMT is the single largest stakeholder in VCTs and EIS, through its provision of tax relief to investors, and therefore it is essential that HMT receive appropriate return on its commitment. We also suggest that the venture capital industry should gather additional data to keep HMT up to date on the scale and type of investments made by VCTs. The BVCA is willing to work with the VCT industry to collate and regularly feedback quarterly data on VCT investments to HMT.[17]

42. The BVCA is aware that some aspects of the VCT scheme could be improved, and funds must be compliant with the spirit of the 2015 decision that VCTs and EIS should provide funding for growing companies. We are therefore keen to work with Government to explore the following changes:

- Remove the grandfathering of excluded trades for funds raised prior to 1998 and 6 April 2008 for new investments. Funds raised prior to 6 April 2007 can be brought within the employee numbers test of s.297A ITA 2007. It would be impractical to amend the 30% eligible shares requirement for VCT funds raised prior to 6 April 2007, given the illiquidity of VCT investments.

- In order to target 'capital preservation' models we propose including provisions in legislation which require that new VCT and EIS qualifying investments should not sub-contract the management of the company's general trade at more than 75% of its costs.

- To address the perception that VCT and EIS money is directed at "asset backed" investments we propose that new qualifying investments in VCTs and EIS should be excluded from partially or wholly contributing to the purchase of a freehold, or lease premiums on leaseholds on more than 25 years.

[16] Pitchbook – *An uncertain future: British VC fundraising in the wake of Brexit*, May 2017 – available here

[17] The BVCA and Venture Capital Trust Association would provide data similar to that provided in Appendix 1

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- We believe the current exclusion list is helpful as it allows the support of innovation and subject to industry consultation, HMT should continue to exclude sectors that it perceives are not meeting the Government's current policy objectives.

- We believe that the existing "no disqualifying arrangements requirement" provisions in sections 178A, 257CF and 299A of the Income Tax Act 2007 could be used to prevent advance assurance being given for investments that involve the setting up of replica companies.

- Extend the 70% qualifying holding test from six months to 12 months. This measure would increase the potential cost-effectiveness of the VCT scheme and have no additional cost to the taxpayer.

43. We believe that the Government should not attempt to reduce the current levels of the reliefs without a fuller analysis of the benefits they bring to the wider economy. This could have the opposite of the intended effect by incentivising managers to invest in lower risk companies to bolster returns. The most recent data from the Venture Capital Trust Association, show that of the investments surveyed, only 9 out of 118 in the total are what could be considered "asset backed". [18]

44. The BVCA and VCT managers would like to work with HMT to address any concerns and provide up to date analysis of the industry, and we believe these figures demonstrate the positive impact that VCTs have on the economy and that the majority of investments fit with what is outlined by HMT in the consultation. We would like to follow up with HMT on all of the points above at a future date.

Q9: Are there other ways the venture capital schemes could support investment in patient capital, in the context of State aid restrictions and evidence on cost effectiveness?

Q12: What other steps could government take to make current tax reliefs more efficient and effective, to provide the best support in line with their policy objectives?

45. Within the current State Aid framework, there are a number of changes that could be adopted that would support further investment in patient capital. The rule changes to the Venture Capital Schemes in the 2015 and 2016 Finance Acts produced a significant increase in response times for applications for advance assurance. This has lengthened the time it takes for eligible companies to receive investment, and we are aware of some companies being pushed into cash crisis and shedding jobs as a result. In some cases, HMRC has also gold-plated some of the EU requirements.

46. The changes outlined below would reduce the degree of subjectivity involved in applying the rules, making the advance assurance process simpler and faster. In some cases, they could obviate the need to seek advance assurance altogether. This would reduce the time it takes to get cash into companies, and would reduce the resources HMRC has to dedicate to the service.

[18] VCT Investment Survey from the Venture Capital Trust Association – see Appendix 1

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47. **The Seven Year Rule** – The greatest source of uncertainty in the rules at present is the restriction on investment in companies seven years after their first commercial sale. Both the GBER and HMRC envisage that companies may make limited test sales without beginning the seven year clock. However, it is not made clear in the Venture Capital Manual exactly what constitutes limited sales to test the market.

48. Similarly, the GBER contains an exemption to the seven year rule allowing investment into companies older than seven years where the company in question is entering a new product or geographic market. As with the beginning of the seven year clock, HMRC permits firms limited sales to test the market for new products or in new geographies before the exemption is closed off. However, there is a similar degree of ambiguity in exactly what constitutes limited sales to test the market.

49. At present, owing to the lack of clarity and the lengthy and uncertain advanced assurance process, many fund managers will not consider investment in companies older than seven years, irrespective of the circumstances. As a result of this, many deserving targets are not receiving the support they need. Providing firms with certainty on the application of the seven year rule would encourage additional investment into firms entering new markets, and firms developing new products or products with particularly long development phases. It would also reduce the burdens on the advance assurance service, and the length of time it takes companies to receive investment.

50. To achieve this, we propose that the Venture Capital Schemes Manual is amended to include an objective test as to when limited sales to test the market have taken place. We believe that a discrete set of sales can be considered limited sales to test the market, within the meaning of the GBER, if the company in question sold no more than six units, or the revenues generated by the sales were no more than 5% of revenues at the time of investment, subject to a revenue cap of £250,000.

51. **The Growth and Development Test** – The growth and development test states that investment in a qualifying holding must be for the "purposes of promoting growth and development of the business of the investee company". This requirement has its origins in UK law rather than the GBER or the EU's Risk Finance Guidelines.

52. Demonstrating compliance with this condition has become extremely burdensome for fund managers. HMRC requires that companies seeking advance assurance must submit a business plan that shows how the company meets this test, and has been known to ask for detailed cash-flow forecasts. Moreover, HMRC's guidance does not give clear and objective criteria that will allow firms to determine whether investments will meet the growth and development test; unhelpfully, the guidance states that "each case will be decided on its own specific circumstances."[19]

53. The BVCA proposes that companies should be taken to satisfy the growth and development test if they are either a seeking investment to grow organically, or for companies over seven years old, seeking investment to fund either the development of new products or entry into new markets (or both). In order to ensure compliance, the fund manager and the portfolio

[19] HMRC Venture Capital Schemes Manual – available here

company should be required to certify that the funding is not being used for replacement capital or loan repayment and that there is no intention to put a time limit on the investment.

54. **Penalty for breach of conditions –** A key reason why VCTs seek advanced assurance is that they stand to lose their VCT status completely if they breach the terms of their VCT approval. This can occur as a result of a single erroneous investment in a non-qualifying holding. Where a VCT does accidentally breach the conditions of its approval, there is currently no provision in the legislation for VCT managers to retain their status by disposing of non-qualifying holdings. Thus, in the absence of advance assurance, VCT managers would be jeopardising their VCT status by investing in companies for which uncertainty exists about whether or not they qualify for tax relief.

55. The number of applications for advance assurance could be reduced, however, if the penalties for a VCT making an honest error were more proportionate. We propose that in the event of a breach on an individual company investment, the sanction could be the clawback of the VCT tax relief for that investment. This would reduce the resources required to run the advance assurance service, thereby improving the cost-effectiveness of the scheme, and increase the speed with which fund managers can invest.

Q10: When is it more appropriate for government to support patient capital through investment rather than through a tax relief?

56. We believe there is a need for a diversity of funding sources that are complementary, including both investment programmes and tax reliefs as they target different needs, and have different investor bases. VCTs, EIS and SEIS allow the wider public to become a stakeholder in entrepreneurial Britain, and government investment programmes support venture and growth funds and draw in private institutional investors.

Q11: Is there an optimum minimum length of time of investment for entrepreneurs and investors to focus on the long-term growth of their company and, if so, what is it?

57. It is difficult to lay down an optimum minimum time period for investment as this will differ based on the kind of investor, the circumstances of the investee company and the purpose of the investment. External factors will also play a role. For example, buoyant public markets could make an earlier exit than would have otherwise been the case more favourable for both investors and investees.

58. Typically, venture capital funds will hold their investments for three to seven years, making operational improvements in their investee companies before exiting, and the five year investor qualification for VCTs is the right time period for commitment to a fund and has worked very well in encouraging more long term VCT investors.

Q13: What scale of new investment should the government seek to unlock and over what timeframe?

59. The BVCA supports the Government's proposal to establish a new National Investment Fund for patient capital. We also agree that the British Business Bank is the natural body for the money to be channelled through.

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60. In terms of scale, the Government should seek at least to match the EIF's investment in UK equity finance. Between 2011 and 2015 this was €2.3bn. It is also important that the Government seeks to avoid the cliff edge risk that the EIF simply withdraws from the UK market without notice before 2019. Despite the EIF's legal obligations, there are already signs that this is happening. The Government should therefore seek to launch the new National Investment Fund as quickly as possible. We would recommend that the Government seeks to ensure the scale of funding providing by the EIF should continue and we understand this is around £400-500mn per annum. The timescale will depend on what time of implementation period/transitional arrangement we have with the EU and the type of future relationship we have with the EIF.

Q14: Should resources be focused on one intervention (e.g. a single fund of significant scale) or spread over a number of different programmes?

Q17: When considering how to support increased investment, should the government consider supporting one or more of the setup of a public-private partnership, a new incubated fund in the BBB to be sold in part or full to private investors once it has established a successful track record and a series of private sector fund of funds to invest in patient capital?

Q18: If desirable, what steps should government take to encourage investors to form a new public-private partnership to increase investment in patient capital?

61. We are supportive of the creation of a National Investment Fund and out of the four options presented (a public-private fund of funds, multiple private sector fund of funds, Green Investment Bank type structure and increased funding for existing programmes), our preference is for further funding for the British Business Bank's existing investment programme. The BBB's scale would become both sufficiently diversified to generate strong returns for itself and private investors, while at the same time investing sums in underlying funds that are large enough to help them achieve the scale necessary to invest across multiple stages, particularly the larger, later stage funding rounds associated with scaling up a business. There is also increasing knowledge about the BBB in the market. It has a good track record and further funding will help bolster this reputation.

62. To achieve scale in UK venture and growth capital funds, we must attract more private institutional investment and ensure there is a diversity of funding sources for UK businesses. This would encompass the bolstering of the BBB's funding, continued support for the venture capital schemes (VCTs, EIS and SEIS) and support for private sector fund of funds. The government should support all of these initiatives rather than focusing resources on a single intervention.

Q15: When considering how to replace EIF investment if the EIF were no longer an investor in the UK, to what extent should the government seek to replicate the EIF's current activities in (a) venture capital and (b) private equity?

63. If the National Investment Fund is to achieve the Government's aim of encouraging private investors into the venture capital market, it needs to generate strong returns. Additional diversification through investment in private equity could help achieve this. The EIF has been an active investor in UK venture capital and private equity funds and the BBB should look to

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replicate this investment programme where possible. This would include reviewing investment criteria to ensure they are flexible, particularly for funds that invest across the UK and Europe.

Q16: Beyond replicating existing EIF investment if required, what areas should government focus on to increase investment in patient capital?

64. The Government should focus on helping UK fund managers achieve scale and our key feedback is noted above. This will improve the ability of fund managers to make meaningful commitments to their portfolio companies over a longer time horizon, investing larger amounts over multiple funding rounds. It could also reduce barriers to attracting private investment by boosting returns through better funded portfolio companies and greater diversification, and by increasing the typical ticket size to enter a fund.

Q19: What steps should the government take to support greater retail investment in listed patient capital vehicles?

65. All of the tax incentives proposed in the consultation paper to stimulate investment in listed funds focus on retail investors. The Government already has an established tax incentivised scheme to encourage retail investment into listed patient capital vehicles: Venture Capital Trusts. There are already a number of established VCT managers, with scale, and investors and the corporate finance and entrepreneurial communities have familiarity with the structure. In order to make a substantive difference to the market, however, the Government needs to encourage institutional investment into listed patient capital vehicles.

66. In order to make listed patient capital funds more attractive to institutional investors, we would propose that institutional investors obtain tax relief of up to 30%, on their other UK dividend income.[20] Thus, for every £1 that an institutional investor in a patient capital vehicle receives in the form of dividends from UK quoted companies, 10 pence may be claimed back from HMRC, up to an aggregate level of 30% of their investment in a fund. This would mirror the reliefs available to retail investors in VCTs.

67. We believe that this would prove particularly attractive to pension funds and charitable foundations who would be appropriately incentivised to increase their weightings in a higher risk asset class. It would thus encourage not only investment in venture capital in the UK by long-term shareholders, but it would also encourage those long term shareholders themselves to invest in UK quoted equities.

68. Another option that the Government should consider, possibly through the new National Investment Fund, is the provision of loans to listed investment funds. The EIB has provided a number of loans to UK listed vehicles investing in life sciences and biotech. In addition to making more funding available, this would improve the returns of the listed funds as a result of the effects of leverage.

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[20] Patient Capital vehicles are unlikely to pay significant dividends, thus the relief would have to be paid on other dividend income to be effective.

Q20: Will focusing resources on increasing investment provide better value for money than changes to the tax environment?

69. See our earlier feedback and comments on the funds ecosystem in paragraphs 6 and 7.

Q21: Beyond measures already being considered to support more effective asset allocation decisions by DB pension funds across their portfolio of investments, what further steps should be taken to support investment by DB pension funds in patient capital?

70. 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[21] in Autumn 2016 setting out the challenges for DC funds investing in private equity and venture capital funds.

Q22: How can individual DC pension savers be best supported to invest in illiquid assets such as patient capital?

71. As more money has flowed into DC schemes, fund managers have adopted default investment options for the members. Defaults have many of the characteristics of a DB fund insofar as they are managed by professionals and invest across a range of asset classes over the long-term, with specific targets in mind. In the US, default options can be very large and highly customised to meet the specific needs of the sponsor's workforce. This bespoke approach facilitates investments in alternatives, which can be mingled with other liquid asset classes so that they are sheltered from the individual participants' contributions and withdrawals. The BVCA is working with other market participants on this area to develop the necessary infrastructure for DC pension savers. Ongoing dialogue and support from the government will be crucial as this work progresses to address regulatory barriers and improve trustees' awareness of the risk profile of patient capital, the potential returns it can offer and ways to address liquidity and frequency of valuations/pricing.

72. In the UK, however, there is a regulatory 'charge cap' on the fees and administrative expenses of 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 well within the cap. As private equity and venture capital funds typically have higher fees than more traditional investment funds, default funds in the UK face a significant regulatory disincentive to invest in these asset classes. To encourage DC investment into patient capital, this issue has to be addressed.

73. We do not believe that the charge cap makes sense from a commercial perspective. Investors will typically look to maximise returns, net of fees and costs. Although minimising costs is one strategy to improve net returns, the charge cap takes no account of the higher returns that can be generated through investments in alternatives. The BVCA's annual Performance Measurement Survey has shown that post-dot com bubble vintage venture capital funds

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

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outperformed the FTSE All-Share on 3, 5 and 10 year IRR basis, after adjusting for the effects of fees and costs. Closing off these opportunities to members of default schemes both reduces the allocation of DC schemes to venture capital, and reduces the retirement income of scheme members.

Q23: Are there barriers to investment in patient capital for other investors that the government should look to remove?

74. Insurers are also significant investors, providing 5% of funds raised by BVCA members in 2016, but the proportion from UK insurers was low at just 1%. 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.

Q24: What steps should government take to support the next generation of high potential fund managers to develop their knowledge and skills and to raise their first or next fund?

75. The BVCA provides a wide range of training courses and we are exploring the possibility of an industry-wide qualification. However, we are not convinced that the UK lacks talented fund managers. The British Business Bank's Enterprise Capital Fund programme has played an important role in establishing a new cohort of younger fund managers. The longer time to bring new funds to scale in the UK relative to the US is more plausibly attributed to a more difficult fundraising environment for European venture funds.

76. The Government could, however, reduce regulatory barriers to entry by streamlining the authorisation process, and introducing a dedicated support unit at the FCA. Many firms find the authorisation process slow and complicated, and the FCA handbook overly complex. Furthermore, when firms use the FCA Hotline they tend to find that they do not get the specialist support they require.

Q25: What further steps, if any, should government take to increase investment into university spin-outs specifically?

77. Investors are restricted from funding university-based innovation due to ownership restrictions on intellectual property. We therefore welcome the Government's commitments in the Industrial Strategy Green Paper to commission independent research into approaches to commercialisation, and a review of the incentives created by the current Intellectual Property System.

Q26: What further steps should be taken to increase investor capability in the public markets to invest effectively in firms requiring patient capital to grow to scale?

78. There are substantial differences between public and private sector investing, particularly in relation to the liquidity of each investment. AiM VCTs are important in this regard, as they enable continued scale in a public environment. Therefore we would be keen to see AiM VCTs given greater flexibility to follow on from successful private VCT-backed companies.

APPENDIX 1 - Venture Capital Trust Association Survey

VCT investment survey from the Venture Capital Trust Association (VCTA)

This summarises the data as of 19 September 2017 from the investment survey for new VCT investments post Nov 2015. We are happy to meet HMT to discuss this information in more detail.

A delegation from the VCTA has collated data from 11 VCT managers to date including all 10 members of the VCTA on new investments made post 2015 rule changes. The data has been reconciled against VCT deal data provided by David Cartwright to ensure accuracy and allow comparison to an overall population.

The sample covers a large proportion of the known new VCT investments post rule change (76% on a monetary basis and 58% of all investee companies). For each VCT manager we have obtained details on the companies invested in as well as the deal structure for all new investments made (quoted and unquoted). The sample has a higher weighting of unquoted deals compared to the total investments, 88% in the sample versus 77% in the total population which will have a slight impact on the average outputs (explained below).

1. **Equity structure –** of the £219.6mn of invested funds covered in the survey, £172.9mn (79%) of this was in the form of permanent equity indicating very low "gearing" on average for post rule change investments. The gearing used was largely secured loan notes (£33.4mn) representing 15% of all invested funds (71% of gearing), with the remaining being preference shares (£8.7mn) and unsecured loan notes (£4.7mn). Due to the higher weighting of unquoted deals in the sample we would expect gearing to be lower for the overall population due to quoted investing largely using permanent equity only. An additional point is that whilst some of the gearing is secured loans this is a measure of "normal practise" from managers rather than a typical expectation that there is any tangible security value to reduce risk.

2. **Size of deals –** 82% of all investments made were for less than £3mn (including any follow-ons in to these companies) with an average investment amount of £1.9mn in the sample. There is a good diverse spread of investments from £500k to £5mn. On top of this only 4% of investments were between £4mn and £5mn. This highlights the typically lower cheque size of investments post rule changes. As the average estimated investment size of those investments not covered in the sample is £0.8m we would therefore conclude that the full population is even further skewed towards smaller investment sizes. This confirms that the industry is backing smaller companies.

3. **Size of investee –** 42% of the sample had less than £1mn of revenue pre-investment and 70% of the sample had revenue of less than £4mn pre-investment. Average headcount of each investment (40 employees) was also significantly below the 250 employees limit. 74% of investments had fewer than 50 employees and 96% had fewer than 100 employees, only one outlier existed above the 250 employees limit.

   The "average investment" per the sample is £1.9mn (of which 79% is permanent equity) into a company with approximately 40 employees and revenue of £3.0mn.

4. **Types of deals –** whilst the data is not yet finalised, it is clear that the vast majority of investments from VCTA members are being made into growing, entrepreneurial led, tech-related businesses. There are some property related businesses – it appears that 4 are businesses based at a single site and 5 are site roll out investments. It should be noted that these investments are allowed today but even so represent only 4 or 9 investments (depending on the definition of property based) out of 118.

5. **Future feedback –** the VCT industry is able to gather data on new investments in this or similar format and is prepared to share this with HMT on a quarterly basis.