BVCA Budget Submission 2009

Contents

1. Introduction and overview

The BVCA represents the overwhelming majority of UK-based private equity and venture capital firms. The UK private equity industry is the largest and most dynamic in Europe, accounting for 57% of the European market, and is second only in size to the United States on the world stage.

As a servant of the real economy, private equity and venture capital have been affected by the economic downturn, both through tightening conditions on their debt in leveraged deals and the economic downturn more broadly, which has made the operating environment considerably more challenging for many portfolio companies.

Alongside this, there has been a significant decline in primary activity, particularly at the larger end of the industry - buyouts have shrunk in size and in number. According to the Centre for Management Buy-out and Private Equity Research (CMBOR), investments by UK private equity firms dropped to their lowest level for over 13 years in the fourth quarter of 2008. The value of buyouts was just £994m in Q4 compared to £5.6bn in Q3 and £5.7bn in Q4 2007. Overall, 2008 £19.1bn was invested in 549 deals, a fall of over 58% on 2007's record figure of £45.9bn from 671 deals.

With a lack of leverage available to finance large deals, the emphasis of BVCA member firms has shifted to managing current investments, and providing capital to struggling companies, making the industry's role more important than ever in the current economic climate. Private equity is virtually unique in having cash on hand (recent estimates by Preqin suggest the industry globally has over $1.02 trillion at its disposal) and the willingness to invest in business when that support is needed most.

As a recent report by the World Economic Forum concluded, private equity companies will be best positioned to attract fresh capital to invest in illiquid markets because they have established track records of aligning the interests of general and limited partners[1]. Unlike other financial institutions, the interests of investors and managers are aligned over a long-term period. There are simply no rewards for failure. Financial rewards are only possible when companies are successful and generate returns and after actual cash is returned to investors.

[1] World Economic Forum: The Future of the Global Financial System A Near-Term Outlook and Long-Term Scenarios, January 2009

2. Regulation

A. Regulatory threats from the EU

The BVCA fully recognises the need for effective regulation in which the public can have confidence. We accept there will be change to the regulatory frameworks in the UK, across the EU and internationally.

Proposals are currently being drawn up by the EU Commission to impose additional regulation on private equity. It is vital that this is done in a way which, a) does not impede the industry's ability to operate effectively; and b) respects areas of national competence. The UK represents 57% of private equity activity in Europe, so any changes would disproportionately impact our members.

In each of the six main areas under consideration, there are sound reasons why the Commission should not act - either because legislation is already in place in the UK, or because those areas are not EU competences (or both). We list these briefly below and would ask HM Treasury to support our case at an EU level.

i) Disclosure, transparency and monitoring

Private equity companies in the UK are FSA regulated, comply with the Companies Act and the International Private Equity and Venture Capital Valuation Guidelines, which address many of these points.

The UK voluntary disclosure regime is working effectively (see next section). A detailed analysis requested by the Commission showed that in the 10 key European markets there are nationally-based codes of disclosure, governance standards and valuations. We continue to believe that any pan-European approach to further disclosure which does not allow for flexibility within member states is undesirable.

As an industry, we have volunteered to unify a Europe-wide set of standards based on common principles but allowing subsidiarity and national implementation of approved variations to fit with local practices and legislation and providing for mutual recognition across member states. These standards would cover conduct, corporate governance, reporting to investors and valuation guidelines.

Countries are very different: Germany, for example, requires formal assessment of disclosure via an accountancy firm audit process. Denmark has a regime similar to the Walker guidelines but with far lower thresholds. France requires membership of AFIC and adherence to its guidelines and prohibits companies from operating outside them. All constitute acceptable country-based approaches which cannot simply be imposed willy-nilly on economies with an entirely different tradition.

The de Larosiere report has suggested a European Systemic Risk Council, and such a body would certainly have oversight of any member state regulatory so inadequate that it posed cross-border risk.

ii) Transparency of compensation structure and managers' remuneration systems

For similar reasons, we do not believe transparency of compensation structures should be a matter for EU regulation. Sir David Walker's report was also clear that compensation structures was a matter for the General Partners (firms) to agree with Limited Partners (investors) and that individual remuneration ought not to be a matter for wider disclosure. Individual countries have different attitudes to privacy of earnings and these should be respected.

iii) Information and consultation of workers (including disclosure of investment strategies and risk to investee companies, and consultation of employees in business transfers)

There are a number of statutory and other binding mechanisms already in place in UK law through which employees are kept informed of company strategy, or which require consultation at times of change:

- The Transfer of Undertakings (Protection of Employment) Regulations (TUPE) are designed to safeguard the rights and obligations of employees in a business transfer.
- Information and Consultation Regulations set out the rights of employees to be informed and consulted on a regular basis on important developments that may affect their interests.
- Under the Takeover Code (via the EU Takeover Directive), companies have an obligation to make disclosures in respect of continuing employment, conditions of employment and pensions provision in a published offer document, when bidding for a quoted company.
- Finally, the Walker Guidelines (above) recommend that: *"A private equity firm should commit to ensure timely and effective communication with employees, in particular at the time of a strategic initiative or a transaction involving a portfolio company".*

iv) Limits on 'asset stripping' and capital depletion

The aggressive depletion of the capital of a business is generally a high risk low return investment activity. In the UK, the Companies Act 2006 and the Insolvency Act 2000 already provide mechanisms to prevent this, via director's responsibilities, restrictions on the distribution of capital, restoration of capital below a certain threshold, financial assistance regulation and so on. But this is clearly a matter of national not EU competence.

v) Limits on leverage

Leverage limits of the sort seen in 2006-07 are unlikely to be seen again. But a one-size-fits-all attempt to restrict leverage on a pan-European basis is both inappropriate and potentially damaging to the economic sovereignty of individual countries.

The main responsibility for determining the level and cost of leverage in a business is the credit provider. Excess leverage is therefore already limited by both existing capital requirements and current market conditions. Other suggested measures, including thin capitalisation measures and limiting the deductibility of interest, are not areas where we believe the EU should set levels, or seek to intervene.

vi) Additional capital requirements (including management companies and at the fund level)

In the UK, private equity managers are already regulated and must register and comply with FSA principles, as well as meet regulatory capital requirements. This is the correct entity within a PE structure to subject to regulation, because this is where investment decisions are made.

The funds themselves are passive investment vehicles and are not leveraged and there would be nothing to be gained by subjecting the funds themselves to minimum capital requirements – it would provide no additional protection to portfolio companies owned by the funds or to creditors.

The timeline is for the Commission to respond on 22 April, so there is now real urgency in addressing these concerns and we ask HM Treasury to support these arguments at an EU level.

B. Walker implementation update

The Walker Guidelines for transparency and disclosure were published at the end of 2007. In January of this year, the Guidelines Monitoring Group, which oversees adherence to the code and is Chaired by Sir Mike Rake, published a report assessing levels of disclosure to date.

Overall, the report found that all companies to whom the code applied were complying with the regime, but that there were some areas for improvement.

Specifically, on portfolio companies' disclosure, the report found that:

- Requirements in the Guidelines to provide information about the private equity firm and the composition of the board and to include a financial review were met in almost all cases although some companies did not include all the required details on the composition of the board.

- All of the companies included a Business Review. In assessing the quality of disclosure made in the Business Reviews the Group has separately considered the pre-existing Companies Act Requirements and the requirements of the Enhanced Business Review. The requirements of the Enhanced Business Review are being adopted on a voluntary basis a year before listed companies are required to do so and therefore do not benefit from the example of existing best practice.

On private equity firm compliance:

- All the firms met the requirement to detail the UK portfolio companies in the private equity firm's portfolio.

- Almost all of the firms complied with the requirement to detail the way in which the FSA-authorised entity fits into the firm of which it is a part with an indication of the firm's history and investment approach. The most common exception was not explicitly to provide any information on investment holding periods.

- All the firms provided information about the leadership of the firm and its UK presence. In some cases the UK leadership structure was not clearly presented but could be inferred from team and contact details on the website.

Criteria and thresholds

The guidelines currently apply to some 32 private equity firms and 54 portfolio companies. This covers 71% of funds under management across the industry and captures the majority of large FTSE 350-size companies whose impact is wide enough to merit such disclosure. However, the guidelines are likely to evolve over time. The Guidelines Monitoring Group will assess whether to amend the guidelines to include a greater number of companies.

We look forward to GMG's decision and respect the need to ensure we have a code which applies to large firms without placing undue burdens on smaller companies.

C. Other regulatory matters

Pensions regulation

Following the announcement of plans to extend the powers of the Pensions Regulator last year, the BVCA engaged in a productive dialogue with DWP officials - and the regulator itself - to explain our concerns with the changes.

Though some progress was made, we were disappointed that a number of our concerns about the scope of the further extension of the Pensions Regulator's powers to issue contribution notices, made by the Pensions Act 2008, were not addressed.

The key issue for ensuring continued support for the funding needs of defined benefit pension schemes, and to avoid them falling into the Pension Protection Fund, is to encourage new investors to provide essential capital to ailing employers. The private equity industry is very keen to support viable employers. But it is unlikely to venture into areas where its investors might inadvertently find themselves suffering severe financial disadvantage through being on the receiving end of a contribution notice, or where one of their other portfolio companies might find itself being required to support another employer's pension scheme.

The proposed restriction – through a code of practice – on the exercise of the Regulator's new powers to cases of '*non-insured buy-outs'* leaves far too much to the subjective judgment of the Regulator. The BVCA repeats its call for greater clarity and certainty in this critical area.

bvca The voice of long-term investment

3. Measures to help small business, enterprise and venture capital

A. A fund to support venture capital and innovative young businesses with high growth potential

The UK has the second largest private equity and venture capital market in the world (after the US) but UK venture capital has always suffered from much smaller fund sizes compared to competitors across the Atlantic. At 0.06% of GDP, the UK invests much less as a proportion of GDP in venture than the US as a whole, at 0.22 %. In California, that figure is as high as 0.6%. In addition, the UK also has a smaller level of investment per early-stage company, so the money is spread very thinly.

This lack of capital means that VC firms struggle to provide the follow-on-funding needed to see a young portfolio company through to profitability.

The current climate is compounding the situation: venture-backed businesses are running out of money. In a recent poll conducted for the BVCA of the VC community by *Populus*:

- There are almost 1,100 VC-backed technology businesses employing around 40,000highly-skilled individuals in the UK.
- 75% of those VC firms polled thought it unlikely that their portfolio companies would be able to find their next round of financing.
- Without that additional funding, over 60% thought their companies would be unable to survive beyond the next 12 months.

As a result, venture capital firms are predicting writing off a far greater number of portfolio companies than normal and there is a risk that the next generation of technology and innovative businesses will be lost.

We believe the Government has an opportunity now to establish a new fund to invest in to the high growth businesses of the future and help the UK invest out of the downturn. This would focus on the UK's strengths to help us continue to compete in areas like low carbon, biotech, electronics and semiconductors.

Other countries have already taken measures to address similar concerns:

- The Belgium Government announced in December a €250m cornerstone investment into a listed venture capital fund to make investments in to early stage companies, including cleantech.
- The Irish Prime Minister recently announced a €500m plan to establish a series of venture-capital funds that will be used to attract innovative overseas firms and boost R&D activity in Ireland. Known as the 'Innovation Fund – Ireland', the measure is aimed at supporting early stage R&D-intensive SMEs, both local and international.

- A NKr20bn (€2.25bn) stimulus package announced by the Norwegian government in January included strong measures for the support of the country's biotech industry. Around €318m has been earmarked for investment in the sector. Half of Norwegian biotech companies said in a survey in December that they would run out of cash in the next 12-18 months without this.

The UK Government could now play a critical and catalytic role by supporting the formation of a new investment fund. This would be a 'fund-of-funds' vehicle, which would invest in venture capital funds raised in the UK and also provide support for existing venture capital fund portfolios. It would aim to attract significant investment from the private sector, thereby contributing to the fundraising of high quality, professional venture capital fund managers who are, in turn, supporting the UK's most innovation-intensive and high growth potential companies.

The overall aim would be to support the growth and sustainability of the UK venture capital sector, cement longer term institutional interest in venture capital and ultimately reach the stage where Government intervention is no longer required.

B. SME tax relief (as per below)

There are a number of changes to a series of SME tax reliefs which would assist the UK venture sector. The BVCA has been calling for these changes for some time and believes now would be an excellent time to make these small alterations to ensure the schemes have their maximum possible impact. More detail in section 6, 2 (taxation) below.

C. Bank lending

The BVCA fully supports the Government's focus on maintaining levels of bank lending to SMEs. Over 75% of the companies in which BVCA members invest are SMEs. They provide a vital source of financing for around 1300 UK businesses a year and, as we enter the downturn, will be one of the very few sources of available capital. We want to ensure that lending to our members is not adversely affected.

A recent survey of BVCA mid-market members[2] showed some examples of negative behavior including: Banks pulling overdrafts where there is no covenant default; trying to force companies to switch from Base margins to Libor margins; and requests for huge fees for basic consents such as amendments to equity documents/articles which are neutral to the company's banking.

The FT reported recently that major banks, including Barclays and HBOS, have announced as much as a 10-fold increase in the annual cost of renewing their short-term overdraft facilities.

Recommendation: The BVCA would like to see a process which allows for swift and consistent decision making, including looking further at a re-institution of the non-statutory London Rules (or something similar); this could include the use of an external review in particular cases that have a bank and distressed company at an impasse and as well as implementing standstill agreements.

We are in active discussions with the BBA and others on this and will keep HM Treasury informed of our progress.

[2] BVCA surveyed mid-market members with a response rate of 49 from 106 companies. Responses covered a total of 324 portfolio companies employing 230,000 employees. In all £19.8bn of debt is held through 673 banking relationships.

D. Limited Partnership Law reform

The BVCA is concerned that the delay to planned reforms of Limited Partnership legislation could have a negative impact on the UK's position as the European centre for private equity.

Limited partnerships are the vehicle of choice for private equity funds in both the UK and across the rest of Europe and the replacement of a century-old piece of legislation has been welcomed greatly to enhance the use of English limited partnerships for these funds. BVCA provided a detailed response to the Legislative Reform Order (LRO) to BERR on 21 November 2008, and the intention has been that the LRO would be implemented from 1 October 2009.

This issue is extremely important to the industry and there is an expectation amongst practitioners that change to the legislation will occur this year. The use of English limited partnerships for private equity funds has become subject to huge competition from other jurisdictions, including Guernsey and Jersey.

Pushing the changes through on time would lead subsequently to the increased use by private equity fund managers of English limited partnerships for their funds, which will improve significantly the attractiveness and competitiveness of private equity in the UK. At this key time for global financial markets, pressing ahead with these reforms will also make an important contribution to allowing the UK to remain the pre-eminent market for private equity in Europe.

Recommendation: We urge HM Government to proceed on the basis of the original timetable in order that the opportunity to maintain UK competitiveness is not lost and would welcome HM Treasury's support.

E. Carbon Reduction Commitment (CRC)

The BVCA supports DECC and the aims of the CRC initiative and we are confident that our members will seek to play their part in helping reduce UK Plc's carbon footprint, as they are increasingly doing through, for example, direct investments into clean technologies.

We are however concerned about the way the scheme will currently be applied. Most of our member firms' companies will be incorporated anyway if they fall above the threshold, but under current plans, the CRC will be implemented in a way which will present a number of significant practical challenges for private equity firms. In addition, it will place portfolio companies at a disadvantage, simply because of their ownership structure.

Under current proposals, the scheme will operate on the basis of group-wide reporting. We agree that group-wide reporting is a sensible procedure - where a genuine group of companies exists. However, under the CRC, the definition used by DECC of 'Group' and the application of the Parent/ Subsidiary Undertaking concept poses significant issues for private equity.

The Parent/ Subsidiary Undertakings concept as a mechanism for identifying a 'Group' works well with commercial companies where there is a common beneficial ownership and purpose. It is however much less useful when trying to describe the relationships that arise in the fund management industry, where the controller of a share is likely to be doing so in a fiduciary capacity and on behalf of a 3rd party investor.

We would suggest that when deciding whether an investee company is within a Group for reporting purposes the conclusion to that question should follow not only the Parent/ Subsidiary Undertaking tests but also the UK GAAP accounting treatment. If the company is consolidated into the balance sheet of the manager then it can genuinely be seen as part of that manager's group and the manager should properly be responsible for reporting. If it is not then the company should be viewed as independent and whether it falls within the scope of the regulations should be question of fact.

This method is also consistent with the existing tax, companies act and GAAP practice and will therefore cause the minimum of confusion and additional work.

We hope this presents a solution which avoids some of the issues outlined above and still enables DECC to meet is policy objectives and would welcome HM Treasury support for this.

bvca The voice of long-term investment

4. Taxation

A. Employee Share Option Schemes

The private equity industry recognises that employee share participation is a potent force for change and improving economic performance. It is key to all private equity transactions, but to date has been largely restricted to senior employees, because most private equity-backed companies are not permitted to establish approved all-employee share schemes. (This contrasts with other sectors where employee share schemes are permitted and commonplace).

This is because the relevant share must not be shares in a company which is under the control of another company, unless that company is itself a listed company. For private equity and venture capital-backed companies, whilst the portfolio company is not itself a subsidiary of another corporate, the definition is based on ICTA 1988 sec 840. Therefore for these purposes the general partner being in most cases a corporate entity will be deemed to control.

The current legislation in this area also inhibits economic activity as it complicates transactions. In particular, following the acquisition of a company by a private equity or venture capital house, it is necessary to terminate these schemes. It would be simpler and to everyone's benefit if the schemes could continue following a change in ownership.

Given that the industry currently accounts for an estimated 1 million employees, we would like to see approved share option plans be made available to all employees of companies backed by our members. In the current economic climate, at a time when the UK savings ratio is at an historically low level, it seems perverse to exclude employees in the companies our members back from saving in highly efficient and attractive low risk vehicles.

There is no policy reason why such employees should be excluded. The current rules are unfair as they prevent large groups of employees from benefiting from the profits generated by a successful UK industry and place a large sector of the UK economy at a competitive disadvantage. There are substantial long term economic benefits for the country if all sectors are permitted and encouraged to operate the best incentive schemes. The BVCA believes this position to be unfair, and an inhibitor to productivity gains and enterprise.

There is appetite from the industry to award these schemes. A number of our member firms have introduced company share ownership plans as a way of granting employees similar benefits to an approved share option scheme. The most common arrangement is one where the company establishes an entity to hold the employees' shares and allows the vehicle to subscribe a significant number of a special class of share on behalf of the employees. These schemes, though, are quite restrictive and as such our members would be more willing to offer share option schemes, as they offer greater flexibility to employers.

There is a strong case for simplification in this area, which is readily achievable and would be allow companies backed by private equity to award approved all-employee share option schemes. These schemes have the potential to play an even more important role in helping incentivize employees in the current economic climate and assisting in the recovery.

The BVCA would welcome the opportunity to discuss how these share schemes can be extended to private equity-backed companies whilst maintaining the rationale behind the various conditions.

B. SMEs : Provisions relating to smaller companies which penalise venture capital and private equity-controlled companies.

Enterprise Management Incentive

Attracting and retaining top management talent in young venture-backed companies is a vital component of enabling these firms to grow and develop in to the world-leading businesses of tomorrow. The BVCA is highly supportive of the EMI, but we feel that two small changes to the scheme could make a significant difference to the ability of venture capital firms in this respect:

I. *Allowing Non-Executive Directors to qualify for the EMI scheme.*
NEDs do not generally qualify for EMI options. This is because the relief is generally restricted to those who spend the majority of their time working for the company by reason of paragraph 26 of Schedule 5 ITEPA.

There is a real need to attract the very best commercial talent to start-up and early stage businesses in a way that does not over burden a young company with excessive salary costs. Experienced executives who are able to provide such key skills to a number of young businesses at the same time through holding two or more directorships are a valuable asset in meeting this need.

The inability of NEDs to qualify for EMI options operates, in practice, to undermine the attractiveness of nonexecutive positions and therefore the desire of key highly-skilled non-executive directors to take on these roles.

II. Increasing the individual option limit to £750,000 (from its current rate of £120,000).
We noted the Chancellor's increase of this limit from £100,000 in Budget 2008, but this made no practical difference to the ability of young companies to attract highly qualified top tier management; the £120k limit remains a real barrier.

As with NEDs, there is a real need to attract the very best commercial executives to (inevitably risky) start-up and early stage businesses and yet to do so in a way which does not over burden a young company with excessive salary costs. Attracting experienced executives is absolutely vital to the development of these companies.

The inability to offer a greater level of EMI benefit to the top executives can, in practice, undermine the attractiveness of such executive positions and therefore the desire of those executive directors to accept the risk involved with taking on these roles.

We believe that increasing the individual option limit and allowing NEDs under the EMI scheme would give a significant boost to start-up and early stage businesses in the UK at a time when these companies are already struggling to find necessary additional financing.

HM Treasury officials have asked us to provide additional evidence of market failure in VC-backed firms, in respect of skills shortages and difficulties in attracting and retaining high quality management talent. A recently published study by King's College London[3] found that stock options and the EMI were considered to be amongst the most effective government initiatives, but importantly:

"The greatest concern related to the recruitment of senior-most personnel such as CEOs. However such executives were unwilling to take high risks in TSBFs (technology-based small firms) and preferred to security of larger firms... For TSBFs with limited financial resources at the outset, it was very difficult however, to attract young professionals and compensate them in proportion to the risks involved."

In addition: *"While the perceived lack of business skills of TBSF management is a key deterrent to investment, the recruitment of appropriate executive directors seems to be particularly problematic in view of the high risks of TBSFs and hence their inability to incentivise executives due to financial constraints[4]."*

We would welcome the opportunity to discuss this report with officials and determine whether this helps provide the evidence base needed to bring about a change in policy.

[3] *Venture Capital Financing of Technology-Based Small Firms in the UK*, Dr Sarika Pruthi, King's College London.
[4] P23.

C. **Other SME tax reliefs:**

For a number of years the BVCA has made various representations to HM Treasury that certain important tax reliefs aimed specifically at smaller companies are being denied to venture capital and private equity-controlled companies, and that this disadvantages these companies against their competitors. The areas of concern continue to include the Enterprise Management Incentive, the Enterprise Investment Scheme and R&D Tax Credits. Small companies who are majority-owned by our member firms are disqualified from these schemes.

-*EMI:* To qualify for this scheme, companies have to be "independent". To be "independent" a company must not be under the control of another company. Because of the precise wording of the statute (which we do not believe to be intended) companies which are controlled by a venture capital investor generally fail to qualify as "independent" and therefore do not qualify for these reliefs. The 'independence test' is contained in paragraph 9 of Schedule 5 ITEPA.

We have suggested a form of words to HM Treasury which we think would overcome this barrier, without leaving the schemes open to abuse. We are keen to discuss this further with HM Treasury officials.

-*Other reliefs:* Venture capital-controlled companies will not qualify for reliefs such as the R&D Tax credit by virtue of the EU SME definition which we believe unfairly penalises venture capital-backed companies because of a concern regarding the way control is defined. In discussions we have had with HMT, it has been made clear to us that this is an issue for us to take up directly with the EU. We have held initial meetings with the relevant DGs at EU level, and will be making further representations. However it would greatly assist our case if HMT was willing to support our case.

D. **Foreign profits**

The BVCA has responded in writing to the consultation on foreign profits and in general is concerned at the additional compliance costs the proposed new rules could cause to companies with private equity backing. There is a potential problem that the current proposals could lead to trapped losses as a result of the tiered corporate structures that are often used for private equity investments.

As noted above, the use of the European definition of SME in UK tax law is a growing problem. It is also an issue in these proposals as the attribution rules in the legislation result in most venture capital or private equity-backed companies failing to qualify as an SME even if in all other respects they are small.

The BVCA is also concerned about the proposed changes to the Treasury Consent rules. There is some uncertainty over the obligations that general partners of BVCA style limited partnerships have under these rules and they risk being a deterrent to UK management of private equity funds if extensive reporting on transactions undertaken by foreign groups in which the partnership has made an investment is required.