Anna Longman
Enterprise and Property Tax Team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

18 September 2014

Dear Anna,

Re: British Private Equity and Venture Capital Association response to the Consultation on enlarging the Social Investment Tax Relief scheme

The British Private Equity and Venture Capital Association (BVCA) is the industry body and public policy advocate for the private equity and venture capital industry in the UK. Our membership comprises more than 500 influential firms, including over 230 private equity and venture capital houses with an accumulated total of more than £200 billion funds under management, limited partners, professional advisers, service providers and international associations, working together to provide capital and expertise to growing businesses, to unlock potential and to deliver enhanced returns to the millions who directly and indirectly invest in our industry. Our members have invested in over 4,500 companies over the last five years, with the majority of UK investments directed at small and medium-sized businesses including start-ups. A growing number of private equity and venture capital managers and their institutional investors are looking at investments that explicitly target a social as well as a financial return.

By way of introduction, the BVCA welcomes the introduction in the Finance Bill 2014 of the Social Investment Tax Relief (SITR), which we think offers good opportunities for direct investment into social enterprises as well as indirect investment via an Enterprise Investment Scheme (EIS)-type 'nominee' fund. The BVCA remains committed to the promotion of the scheme to investors and notably within the venture capital and investment community in order to further drive the development of the social investment sector and thus we welcome the general direction of travel as set out in the consultation document. We think the key factors in successfully attracting a meaningful amount of non-philanthropic capital to SITR advantaged funds would be to (i) substantially increase the investment limit under the scheme to £5m p.a. and (ii) permit indirect investment through a Venture Capital Trust (VCT)-type structure and (iii) to provide an equivalent, or enhanced, package of tax reliefs when compared with EIS. We reiterate our call for an ambitious scheme in order to really seize the ongoing momentum around social investment.

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According to the 2014 survey by JP Morgan and the Global Impact Investing Network, 125 global investors, including fund managers, banks, foundations, development finance institutions, and pension funds expect to commit 19% more capital to impact investments in 2014 compared to 2013, as satisfaction with the financial returns and the social and environmental impact of these investments remains high. From a PE/VC perspective, we believe that the social investment strategy would build on the hallmarks of the PE/VC asset class to meet the needs of social enterprises, looking for long-term finance, scale and innovative approaches.

Investment limit per investee organisation

The main barrier which at present seems to hinder social investments is the size of the investment limit under the SITR. Currently the maximum permitted investment size per social enterprise is set at €344,827 (about £275,000) over three years, which does not require European Commission approval. We strongly support the Government's efforts to introduce a larger scheme with a higher investment limit, and believe there is scope for such a move under the EU Risk Finance Guidelines. The flexibility contained in the guidelines means that it can plausibly be claimed that any social investment, delivered through an intermediary which offers tax relief to its investors should be subject to the provisions of the Risk Finance Guidelines. We also encourage the Government to provide as much visibility as possible of the State Aid clearance application process. The lead time to raise a new fund and to originate a qualified investment pipeline can be significant and visibility on the State Aid process may enable fund managers to commit resources sooner.

The BVCA reiterates its call for increasing the annual investment limit to £5million per year per social enterprise under an expanded SITR, as it currently stands for the tax-advantaged venture capital schemes EIS and VCT that aim to help bridge the funding gap for small high-risk companies. We believe £5million is a suitable investment limit that would incentivise both providers of risk finance capital as well as institutional investors, thus create a fully functioning market and ensure the viability and take-up of the SITR.

A survey from Clearly So referenced in the consultation paper[1], says that in 2012, fewer than 10% of respondents were looking for investment of amounts between £1m and £5m, and fewer than 5% for amounts over £5m. We note that at the moment the main source of finance for social enterprises comes from banks, as evidenced in the City of London report[2], with estimates that four banks accounted for 82% of the social investment market in 2013. Banks invest almost entirely in secured loans, providing a predictable return. But social enterprises lacking substantial endowments or property assets on which to secure loans find it all the more difficult to raise debt finance from banks. Research carried out by Albion Ventures this year showed that unsecured loan funding with a maturity of ten years would be of interest to a number of social enterprises

[1] Clearly So, New Philanthropy Capital, 2012
[2] https://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Pages/Growing-the-social-investment-market.aspx

for their development plans. High risk capital is the type most required by social enterprises, as demonstrated in a report prepared by the City of London and Big society Capital in March 2013[3]. The role of a higher investment limit to make the expanded SITR viable is crucial to unlock this source of high risk capital. Failing to reach a certain scale would mean advisers and intermediaries would not be able to offer a share of such a small fund to their clients.

It is also the case that more mature social enterprises have funding needs which they do not expect to be suitable for bank finance. Institutional investors whose preferred investment size would be a minimum of £10 million, tend to invest via a limited number of social venture capital funds (the largest of them being managed by Bridges Ventures) in order to gain the size of investment required. Whilst institutional investors have so far played a minor role in building up the social investment sector, they represent a multi-billion pound opportunity to invest in less risky, more established social industries, estimated as the “next £5bn” of investment capital, according to a recent research by City of London[4]. Despite the recent successes of Bridges Ventures and others, the growth of social venture capital has been slow and there is a risk that it may not be able to keep pace with the rising demand for funding. Increasing the investment limit per investee organisation to £5m to include many, if not all, social venture capital funds would unlock institutional money to serve the social investment sector and help social enterprises to gain access to the “next £5bn” of investment capital.

Indirect investment options

While EIS-type nominee funds will more likely be used by angel investors, a VCT-like scheme will more likely be used by the mainstream investment community, therefore unlocking a larger source of capital. We welcome the option for expanding indirect investments via a separate legal entity modelled on VCT, as this is a structure well known by investors and praised for its transparent, evergreen and long-term value – therefore suitable for social investments. The BVCA agrees with the Government’s preferred approach to set up an entirely new bespoke structure for social enterprise drawing on the experience of VCTs, rather than amending the existing VCT scheme. We believe that in the attempt to set up such social investment VCT, the existing VCT provisions should be mirrored as much as possible, whilst also taking into account the specificities of the social enterprise sector and the need to make the market most attractive to investors. We think it is important that an AIM listing is permitted (rather than a full listing required by VCT legislation), to enable a lower cost model whilst providing sufficient visibility for investors.

3 http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/the-role-of-tax-incentives-in-encouraging-social-investment-WebPDF.pdf

4 http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Pages/New-specialist-sources-of-capital-for-the-social-investment-market.aspx

A pure social investment VCT scheme:

It is our assumption that, as with the existing SITR, the indirect social investment vehicle is aimed primarily at high-net worth individuals (HNWIs) and it is our understanding that overall HNWIs are more attracted to EIS than VCTs investments - with eligibility for capital gains tax (CGT) deferral and business property relief (BPR) being a key driver for such an investment choice. By contrast, the tax relief associated with VCT which does not feature in EIS provisions is the Dividend Relief, which in a social investment context, is unlikely to be a decisive factor for HNWIs given that social enterprises are unlikely to pay large dividends (due to restrictions that both Community Interest Companies and Community Benefit Societies have in making distributions to shareholders).

Intermediaries and investors are likely to compare products based on their risk-adjusted return. With a view to mitigating the risk profile of social VCT investments (which compares unfavourably with that of commercial VCTs investments due to the lower returns expected from social investments, but also with the risk profile of EIS investments due to the listing and administration cost of multiple small scale VCT investments), we recommend that a social investment VCT should offer greater incentives than the commercial VCT structure currently does.

We note the existing SITR provides 30% income tax relief and CGT deferral. We believe that to move social investment VCTs from the niche to the mainstream requires a VCT-type structure offering EIS-type reliefs.

We believe the current SITR package will drive a reallocation of a proportion of philanthropic giving towards SITR funds but is unlikely to attract a meaningful volume of mainstream investors to social enterprise. If the SITR and EIS had equivalent tax incentives, we think significant new money will be attracted to Social Enterprise as many investors are likely to be willing to sacrifice some financial return in return for the social impact. We think it is unlikely that significant investment will be attracted to SITR funds if the latter have both an inferior package of tax reliefs to EIS as well as a lower expected financial return on loans made to charities.

In addition, whilst financial returns from SITR investments are likely to be modest, they are likely to be exclusively in the form of income and thus income tax relief on dividends (a VCT relief, not included in the EIS scheme) would be meaningful to SITR investors. Thus we think the following reliefs should be included in the package:

- BPR should be available on investment into social VCTs. To this end, we recommend that two changes are made: i) Social-VCTs should be able to list on the Alternative Investment Market rather than being required to fully list on the London Stock Exchange or other regulated market, ii) Social-VCTs should be deemed to be carrying on a business for BPR purposes.
- Loss relief to limit downside, particularly as a social VCT would have no capital upside.
- Income tax relief on dividends received from the social investment VCT.

Hybrid VCTs

On the debate between a hybrid structure and a pure social impact VCT model, while there is consensus building among our membership around a pure social model, we note the interest of some investment managers in hybrids as a starting point allowing them to test the market before launching any purely social vehicle. A hybrid structure offering a mix of commercial and social investments could make it easier to mitigate risks and returns.

We think it would not be reasonable to offer different tax breaks for a hybrid VCT, nor would it be easy to structure. In our view a hybrid VCT structure should have the standard VCT tax reliefs – i.e. 30% up front income tax relief for subscriptions of new shares, and for any acquisition of shares, Dividend Relief and Capital Gains Tax exemption.

We would recommend however the following amendment in relation to the VCT investment rules:

- to scrap the minimum 10% equity in each investee company, and
- to not apply the VCT requirement to invest 70% of qualifying holdings in ordinary shares for the proportion of the hybrid VCT that is in social investments (so that proportion could be 100% debt) – i.e. favour the current SITR approach that both unsecured debt and equity investments would be eligible.

This amendment reflects the assessment made by the Treasury in its consultation paper that many social enterprises do not issue shares and most social investment currently occurs by way of debt because they don't use the "normal" corporate structure.

Investee organisations

The Government proposes to apply the same eligibility rules to the investee organisations under a social investment VCT, as the current SITR. Eligible organisations are then considered a social enterprise, including:

- a community interest company,
- a community benefit society,
- a charity.

These qualifying organisations are in practice most often companies limited by guarantee. We would like to emphasize that some investors may find it disappointing that the relief only applies to companies limited by guarantee, rather than a more inclusive definition that would capture "normal" limited companies - as required by VCT legislation, and as embedded in the 'Impact Continuum' put forward by the Social Impact Investment taskforce established under the UK's presidency of the G8.

In conclusion, we believe that the SITR can have a galvanising influence on the impact investing market, encourage new investors to commit capital, social enterprises to raise more for more ambitious projects, and market-making intermediaries to connect end users and interested investors. We are seeing an increased interest from investors, whether they be HNWIs looking for a return or venture capitalists looking to raise funds in this burgeoning asset class. The SITR can build on this early momentum and help normalise the idea of seeking a social return, alongside a financial one.

The key to this remains the size of the opportunity. With the investment limit per social enterprise as it stands, there simply isn't the scale and market to allow the intermediaries and financial advisors to offer these opportunities to their clients. Without them we are relying on ad hoc fund raising which will limit the availability of capital for social enterprises. That is why the most important action required is to seek state aid clearance for a larger limit of 5m, and offer as much visibility on this process to the investment community.

Secondly, we believe that the most appropriate investment structure to channel this capital is the VCT. This indirect investment model has proved extremely successful, delivering consistent returns for investors, much needed growth capital for businesses and good value for money for the taxpayer. There has been debate as to whether we should combine social impact investing with conventional VCT investing in hybrid vehicles, or whether it would be more advantageous to design and create a pure social impact VCT. Whilst we can see the advantages of pursuing the hybrid model, in particular whether enough capital can be raised for a pure social impact VCT, we believe that the risk/return profiles of the two investment strategies are different, and therefore would be better managed separately. To encourage sufficient capital to be raised in a pure model, we would encourage the government to offer EIS type reliefs in a VCT structure. These should be sufficiently attractive to encourage the necessary level of investment. This combination of higher investment limits and generous EIS type tax breaks in a VCT structure, will be a great fillip for this vital asset class.

We would be delighted to meet you to discuss our feedback further. Please feel free to contact Marie Audren at the BVCA (maudren@bvca.co.uk).

Yours sincerely

Tim Hames

Director General, British Private Equity and Venture Capital Association