National Security and Infrastructure Investment Review
Consumer and Competition Directorate
Department for Business, Energy and Industrial Strategy
1st Floor
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London
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By email: nsiireview@beis.gov.uk

14 November 2017

Dear Sirs

Re: National Security and Infrastructure Investment Review – BVCA response to the Green Paper (Chapter 7)

1. We are writing on behalf of the British Private Equity and Venture Capital Association ("BVCA"), which is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 600 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. Further information on our members' investments and contribution to the UK economy is set out in Appendix 1.

2. We welcome the opportunity to comment on the questions posed in National Security and Infrastructure Investment Review. This response relates solely to the questions raised in Chapter 7 of the Green Paper – we intend to comment separately on the questions raised in Chapter 8 of the Green Paper in due course.

The private equity model

3. Understanding the key features of the private equity model is relevant in understanding the BVCA's response below. Private equity and venture capital firms are long-term investors, typically investing in unquoted companies ("portfolio companies") for around three to seven years. Firms will often sell their stake in a company by listing on the public markets or selling to a strategic buyer.

4. There are three key stages of the private equity and venture capital investment cycle:

    a. **Fundraising**, during which managers raise capital from investors. These investors are typically institutional or professional investors such as pension funds and insurance companies.
    b. **Investment**, during which managers source deals and put capital to work by investing in companies that are typically unquoted and SMEs, investing alongside management and founders and supporting these companies through their development and growth.
    c. **Exit**, selling or realising investments and providing returns for investors.

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5. Barriers that make any of these stages more difficult or costly therefore impede the ability of our members to invest in UK companies and provide returns to their investors in an efficient manner.

6. Our members have demonstrated their consistent ability to outperform other asset classes. On a since-inception basis, UK funds returned 14.1% (net of fees) in 2016, and the 10-year IRR generated 11.0% (net of fees), nearly double that of the FTSE All-Share Index.

Our overall view on the Chapter 7 proposals

7. We do not believe that it is appropriate to extend the legislation in the manner proposed by secondary legislation. The proposed amendments are not minor or consequential; rather, they represent a significant extension of the scope of the Enterprise Act 2002 (the "Act"). We therefore believe that the proposals in Chapter 7 should be considered as part of the wider Chapter 8 consultation. Further, we have doubts as to the ability to amend section 23(1)(b) of the Act under the power granted by section 28 beyond a simple change to the monetary amount, for example to cater for inflation.

8. Any significant reduction in the jurisdictional thresholds below the current £70m will inevitably bring into scope many transactions for the acquisition of UK businesses (including as part of the wider acquisition of an international business) which, at present, are not subject to the provisions of the Act. This will impose additional burdens on participants in such transactions, which will disproportionately impact smaller transactions.

9. Our concern is not primarily that the Government will block "in scope" transactions that do not present national security concerns. It is important for parties to a business acquisition transaction to be able to understand all the risks relating to the execution of that transaction in advance. In order to do so, if the proposals set out in Chapter 7 of the Green Paper are implemented, the transaction parties will first need to identify all items designed or manufactured, and all related software and technology held by the target business, which fall within the Strategic Export Control Lists or which fall within the widely drawn advanced technology definitions. Given the complexity and highly technical descriptions of many of the items on the Strategic Export Control Lists, and the vague nature of the proposed advanced technology definitions, in many cases that identification will not be a straightforward task. Once the parties have determined that a transaction is within the provisions of the Act, they will then need to assess whether the transaction might raise competition or national security concerns. All this adds to the cost of a business acquisition and extends the timeline for such transaction.

10. Given that the Government's sole objective is to address national security issues, if it implements these proposals it should do so by amending the special public interest regime in sections 59-66 of the Enterprise Act, as that would allow qualifying transactions to escape a review on competition and other public interest grounds. The only conceivable reasons for not doing so are to avoid the need for primary legislation, or to implement a temporary regime that can be used to carry out national security reviews pending the passing of the longer term reforms through primary legislation. We do not consider that the short term reforms are sufficiently urgent to merit that approach, as if primary legislation is appropriately prioritised there are unlikely to be any significant transactions that would

escape review in the intervening period. We also note that the Government itself does not appear to consider the reforms to be particularly urgent, having announced its intention to introduce them over a year ago, in September 2016.

11. If the Government nevertheless intends to proceed with proposals to extend the scope of the Act, we believe that any such extension must:

- clearly define the sectors which are covered;
- relate only to sectors in respect of which there is a significant national security concern; and
- be proportionate and workable.

12. We do not believe that the proposals set out in the Green Paper meet these criteria.

Responses to Chapter 7 questions

1. Do you think the proposed definitions for the dual-use and military and advanced technology sectors provide sufficient clarity and certainty to businesses and investors?

Dual-use items

13. The inclusion of dual-use items in the proposed jurisdictional tests potentially brings into scope many businesses which manufacture or hold items which present no national security concerns.

14. In particular, we do not believe that the following items on the Strategic Export Control Lists should be within scope of an extended Act:

- Items which are on the EU Dual Use List but which do not appear in Annex IV to Council Regulation (EC) No. 428/2009. These items may be transferred within the EU without restriction and it therefore seems to us inappropriate to include such items, as by their nature they cannot be particularly sensitive from a national security perspective.

- Items on the UK Dual Use List the export of which is prohibited only to certain territories. For example, marine vessels, related equipment, components, software and technology are prohibited for export to Iran under PL9008 of the UK Dual-Use List. We assume that it is not intended that the manufacture of non-military marine vessels should bring a business within scope of the Act.

15. Accordingly, if the Government seeks to amend the Act by reference to the Strategic Export Control Lists, we believe that it should do so by producing a separate list, which contains only those items for which there are genuine national security concerns, selected from the following lists: (a) the UK Military List, (b) Annex IV items on the EU Dual-Use List, (c) items on the UK Dual-Use List which are subject to intra-EU transfer restrictions, and (d) the UK Radioactive Source List.

16. Given that many of the small businesses potentially caught by the new regime will not be exporters and therefore will never have had cause to consider whether their products fall

within the listed categories, any use of these lists should be accompanied by an increase in the Government resources that are available to businesses to assist in the determination of whether items are covered by export controls.

Advanced technology

17. If a particular piece of technology is not on a Strategic Export Control List then it may be freely exported outside the UK and should not present a national security concern. It would therefore be inconsistent if the ownership of such technology were to be made subject to public interests controls. Accordingly, we do not consider it necessary or appropriate to specify technology outside the Strategic Export Control Lists.

18. In relation to the definitions themselves, we are not experts in advanced technology but it seems to us that the definitions are drawn very widely; for example, "intellectual property rights in the functional capability of multi-purpose computing hardware" would, on its face, cover a wide range of rights. If advanced technology is to be brought within a widened regime, the definitions need to be clear and precise so that the parties to any transaction can readily understand without having to invoke significant resource and multiple advisers whether a business is caught.

2. Do you think the scope of the new thresholds should reflect updates to the relevant Strategic Export Control lists? Do you think that enterprises that design or manufacture items subject to *temporary* export controls should also be in scope?

19. If updates to the relevant lists are to be reflected in the thresholds, it is important that transaction parties have certainty at the time of entering into that transaction. Accordingly, changes to a list following the entry into of a transaction (including prior to completion of that transaction) should not be taken into account in assessing whether the regime is applicable.

20. As stated above we believe that, if Strategic Export Control Lists are used to define the thresholds, they should be limited in scope to areas of genuine national security concern. We therefore do not believe that items subject to temporary export controls should be in scope.

3. Are the proposed definitions sufficiently focused on sectors where national security concerns may arise? If not, what amended definitions would help achieve this?

21. See above.

4. Do you agree that the new jurisdictional tests in the Enterprise Act 2002 for businesses in the above defined sectors should be:

• a turnover of over £1 million, rather than £70 million as now; and/or

• a merger or takeover involving a target with 25% or more share of supply (i.e. with no need for an increase), or which meets the current test of creating or enhancing a share of supply of 25% or more.

22. The effect of the proposals to lower the jurisdictional tests set out above is effectively to bring all acquisitions of businesses carrying on an activity in the relevant sector (other than very small businesses) within the scope of the Act, including both the competition and public interest provisions. Transactions in respect of which previously the parties need not have considered competition (merger control) issues or national security interests will now be caught. This will introduce uncertainty and increase transaction costs in relation to an extremely large number of even very small transactions, inevitably reducing investment incentives. We are also concerned that expanding the scope in this way will place a significant burden on the CMA which may not have sufficient resource to assess transactions on a timely basis. Extending timelines significantly often impedes transactions and therefore negatively impacts our members' businesses.

23. Moreover, given that the proposed removal of the requirement for the transaction to *increase* share of supply would already capture a change of control over any business with material market power in the relevant sectors (regardless of size), it seems disproportionate to also lower the turnover threshold so dramatically.

24. For the reasons set out above, we do not believe that such an extension is justified (or, indeed, any other arbitrary threshold between £1m and £70m).

5. Would Government guidance in relation to its views about the amendments, including their solely national security focus, be useful? If so, what would it most helpfully cover?

25. Government guidance can never be a substitute for tightly drafted legislation. Accordingly, so far as possible the determination of whether a particular transaction is caught should be readily ascertainable on the face of the legislation.

26. While guidance from Government that the proposed amendments are focused solely on national security would be helpful, the amendments (if made in the manner proposed) will expand the jurisdictional scope of the competition merger control provisions. Whatever guidance the Government may provide, buyers of "in scope" assets will need to give consideration to any competition aspects of the transaction, as well as national security issues.

27. While information relating to merger control decisions (both in the UK and the EU) over a period of many years is publicly available and assists parties' advisers in assessing the competition risks of a transaction, very little guidance exists in relation to the UK's approach to national security issues. The proposed amendments will therefore create uncertainty in transactions within the legislation's scope. In order to address that, it is important that transaction parties and their advisers are able to access comprehensive and reliable guidance. Given the sensitive nature of the subject matter, we expect that the Government may be reluctant to provide detailed public guidance on certain areas (for example, whether particular individuals, enterprises or states give rise to particular concerns). It may therefore be necessary for the Government to provide confidential case-by-case guidance to potential transaction parties before a transaction is entered into.

28. Indeed, our members' experiences in other countries (in particular, the United States) indicate that the ability to obtain such case-by-case guidance will be important to the proper

functioning of an expanded national security control regime. It seems to us that this will, inevitably, require increased Government resources to be made available in order to be able to provide such guidance in a timely and efficient manner. The need for increased resources will become even more acute if any of the options for a further expansion of the regime proposed in Chapter 8 are adopted, particularly if a mandatory notification regime is introduced (which we intend to oppose in our response to the Chapter 8 consultation).

6. What do you think are the most important costs and benefits from the proposed threshold changes to the Enterprise Act 2002 for the defined sectors? What could be the potential size of these costs and benefits?

29. We have been unable to identify any benefits of the proposals for the defined sectors. As you will appreciate, it is difficult to estimate the scale and costs of the proposed changes, as that requires an assessment of both the number of transactions which are possibly within scope and the number of transactions which are actually within scope (and that will therefore need to be analysed further). However, we expect both to be significant. As discussed on our call, we will consider further whether we are able to obtain and provide to you evidence to aid such an analysis.

30. While we do not believe that the Government's proposals will necessarily halt investment in the relevant sectors, any uncertainty or additional regulatory restrictions will inevitably present a barrier to investment in the UK and therefore adversely impact the competitiveness of the UK economy at a time when we are already experiencing economic uncertainty due to Brexit. Furthermore, extending the time periods for closing transactions or adding uncertainty to such timing impacts the availability and pricing of financing for such transactions, also detracting from the UK as a location for investment by our members. In particular, it is worth considering the potential negative effect the proposed amendments could have on investment in innovative and high-tech sectors.

31. We would be happy to discuss the contents of this letter further with you. Please contact Gurpreet Manku (gmanku@bvca.co.uk) at the BVCA in the first instance.

Yours faithfully

Amy Mahon
Chair, BVCA Legal & Accounting Committee

Appendix 1

BVCA members' investment and contribution to the UK economy

- Our members have invested over £27 billion in nearly 3,800 UK-based companies over the last five years.
- Private equity and venture capital funds managed in the UK currently back around 3,200 companies, employing over 1.1 million people on a full-time equivalent basis ("FTEs") across the world. Of these, around 448,000 FTEs are employed in the UK.
- In 2016, 16 companies experiencing trading difficulties were rescued by BVCA member firms, helping safeguard around 6,700 jobs.
- In 2016, around 925 companies, employing around 310,000 FTEs, were invested in by private equity funds managed in the UK. Of these, around 728 were in the UK, employing around 126,000 FTEs. (2015: 795, 2014: 728).
- 61% of investments were in small companies, with around a further 26% being medium-sized companies.
- During 2015, 24,400 firms operating in the UK received venture capital or angel backing. The vast majority of these firms were start-ups and small businesses. Around 50% of investment was concentrated on the digital economy in key strategic sub-sectors like online, media, entertainment and telecoms. Venture capital investment is specifically targeted at innovative and hi-tech sectors.[1]

EY report on the performance of portfolio companies

This report (www.bvca.co.uk/Research/BVCA-Research-Reports) provides comprehensive and detailed information on the effect of private equity ownership on many measures of performance.

- The data is collected for companies subject to the Walker Guidelines on disclosure and transparency. They cover the largest PE-backed companies in the UK.
- Portfolio companies have much higher levels of financial leverage than public companies, 6.5x net debt to EBITDA versus 2.4x, respectively.
- The total equity return on 64 portfolio companies that were exited by PE investors in the period 2005-15 was well in excess of the comparable public company benchmark, by a factor of 4.3. This significant outperformance is explained in equal measure by PE's strategic and operational improvement, and the net benefit of additional financial leverage.
- Organic employment growth at the portfolio companies has been faster in the last two years, averaging c.3% per annum, consistent with economy-wide benchmarks.
- Investment at the portfolio companies has grown by 1.6% to 7.6% per annum across a number of measures.
- Annual growth in labour productivity in the portfolio companies at between 2.0% and 2.4% is on a par with public company and economy-wide benchmarks.
- The portfolio companies have grown reported revenue at 5.8% per annum and profit at 4.6% per annum; organic revenue and profit growth are both 3.6% per annum.

[1] The contribution to the UK economy of firms using venture capital and business angel finance, Oxford Economics & BVCA, April 2017