BVCA Funding the future

BVCA Budget Submission 2012

Executive Summary

The private equity and venture capital industry is confident that we can help deliver economic growth with the capital we are currently looking to invest as well as through driving the growth potential of our many existing portfolio companies. There are two key areas of interest and concern for private equity and venture capital to help restore our economy: the immediate need to boost the financing of SMEs and start-ups and in the medium term, improving the competitiveness of our tax and regulatory regime.

Financing SMEs: Venture funding is on the decline. It is imperative that we look at policy to encourage institutional investors to invest in the asset class. We have proposed EIS Funds where institutional investors could combine with retail investors to help raise larger funds as well as similar proposals for VCTs. In addition, we have also proposed a form of credit easing for VC funds to assist them with new punitive capital standards. By allowing tax relief for both classes of investors, this would be a significant fillip for the financing of growth companies. We have also proposed measures to allow great participation in social investment via EIS and VCTs.

Supporting entrepreneurs: People who start a new business, work for one, finance one or even simply provide mentoring and support, deserve recognition. That is why we have proposed reform to Entrepreneurs Relief (ER) by removing the 5% holding test to allow smaller employee shareholders to qualify, and removing the employment requirement so that ER is deployed as an incentive to High Net Worth Individuals (HNWs). We would also encourage broader participation in company share schemes to help foster a savings culture. Employees could be put on the same footing as founders by allowing shares awarded via the Enterprise Management Incentive to qualify for Entrepreneurs Relief. Furthermore relaxing significantly the working time tests to allow non-execs and university academics to qualify would allow greater participation.

Competitiveness – Tax: We continue to support the downward trend in corporate taxation and the commitment to creating a culture of certainty and stability is the right approach. Capital Gains Tax remains high by international standards but again we welcome the commitment to retain the current regime for the life of this parliament. On taxation of non-doms it is imperative that the taxpayer gets value for money and the need to guard against tax avoidance should remain paramount; but unless the current scheme to allow income remittance into the UK is amended it is unlikely to enjoy significant take-up.

Competitiveness – Regulation: Domestically, we welcome the Government's focus on needless regulations that impact on UK businesses and the BVCA have submitted a separate response to the "Red Tape Challenge". Our principle concern remains regulation from the EU notably the Institutions for Occupational Requirement Provisions Directive (IORP). This would apply Solvency II standards to pension funds which has the potential to massively impair their ability to invest in real economy assets like venture capital and private equity. On employment, we fully endorse the Beecroft Report as a step in the right direction. In particular, a "no fault" termination similar to that applied in the USA where notice is given under the employment contract would create a more efficient process as well as encouraging a more flexible and fluid workforce. We have also suggested reforms to the Tier 1 Entrepreneurs Visa, which is not working as it should be.

About the BVCA: The British Private Equity & Venture Capital Association (BVCA) is the industry body and public policy advocate for the private equity and venture capital industry in the UK. The BVCA Membership comprises over 250 private equity, midmarket and venture capital firms with an accumulated total of approximately £32 billion funds under management; as well as over 250 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally. As a result of the BVCA's lobbying and reputation-building efforts, private equity and venture capital today have a public face. Venture capital is behind some of the most cutting-edge innovations coming out of the UK and that many of us take for granted: the medical diagnostic services we use in hospitals, the chips in our mobile phones, the manufactured components of our cars, and the bioethanol fuels that may run them in the future. Likewise, private equity is behind a range recognisable High Street brands, such as Boots, Phones4U, Birds Eye, National Grid and RAC.

The impact of private equity and venture capital

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- BVCA members have around £72bn of dry powder to commit, much of it in the UK. Our ability to deploy it will depend on economic, tax and regulatory stability. The current investment climate is hindered by uncertainty, however, in private equity at least, London will remain competitive if stability and continuity are restored and maintained

- Data from BVCA members show that private equity and venture capital firms invested £20.4bn globally last year (2010 data), up from £12.6bn in 2009. Almost a thousand companies benefitted from the funding and expertise of BVCA members as they backed private sector firms to drive economic growth

There are two key areas of interest and concern for private equity and venture capital to help restore our economy: the immediate need to boost the financing of SMEs and start-ups and in the medium term, boost the competitiveness of our tax and regulatory regime

1) Financing Entrepreneurs and SMEs

Venture capital is the flow of equity into innovative companies; it funds a breeding ground for ideas and inventions. Government support whether in the form of tax breaks, underwriting or direct investment is a huge net gain for the economy. Measures to encourage greater investment will pay back a dividend through corporation tax, job creation and innovation.

- Venture capital-backed businesses showed stronger turnover growth between 2006 and 2010 than other enterprises, with VC-backed companies trebling sales compared with more modest growth at comparable companies. Profit growth was also stronger at VC-backed businesses.
- Job creation was also much stronger within VC-backed companies, with an 80% rise in employment over the four year sample period. In comparison, other enterprises saw very little change in overall employment numbers.
- Overall, gross profit margin at VC-backed companies was broadly comparable with other enterprises. Turnover per employee - a proxy for productivity - was also broadly similar over the sample period as a whole[1].

We strongly welcome recent reforms to both EIS and VCTs and would encourage the Government to continue to seek state-aid approval. We also welcome the new SEIS scheme for start up investment. Early feedback is positive though we would suggest lifting the limit to the first £500,000 invested in a start up for the first two years of trading – at this stage of a company's development, this funding would be used for recruitment so this limit would allow for faster development and a bigger impact on the UK economy

While recent Government initiatives in areas such as EIS and VCTs are helpful, the impact of these is clearly dwarfed by the overall shortage of finance for SMEs. A major element of this is driven by the inevitable de-leveraging of UK banks. We therefore welcome measures to increase debt finance through non-bank channels and would urge the Government to work with private equity and venture capital to aid delivery – particularly in the case of the Business Finance Partnership. It is also important to note the increasing disinclination of institutional investors to back venture capital, both in the UK and throughout Europe. The Government should consider how to support early-stage and start-up businesses in the context of credit easing – these are precisely the companies that will struggle to attract financing in the current climate.

In addition, we recommend a number of measures designed to remove anomalies governing the taxation of rewards for entrepreneurs and their backers, with a view to enhancing the incentives for this crucial segment of the UK economy.

Institutional Fundraising for Venture Capital

Despite the robust performance data above, fundraising for UK venture capital is going through a sustained period of decline; it has reduced to a low of £478m in 2010. This is in no small part down to institutional investors. Across the whole of Europe, they have reduced their commitments to venture capital by a factor of nearly 10 since 2008. Public sector commitments have been sustained since 2007 but this should not be relied upon as the mainstay of VC fundraising. We propose three options to alleviate this.

[1] BVCA Research, see http://admin.bvca.co.uk/library/documents/Experian_final2.pdf

1) EIS/LP alignment –EIS Funds, a new class of investor

There is clear need to join up tax incentivised savings with conventional institutional investor money, particularly as the investment limits have increased. There is an opportunity to raise new money from would be EIS investors using a fund structure and use this to attract further investment from institutional investors providing a significant fillip for high-growth UK SMEs seeking finance.

To avoid distortion and duplication, a framework needs to be devised such that a fund could qualify for EIS relief provided it makes only the requisite investments. Furthermore, there is also an opportunity to create a much needed multiplier effect. This will allow larger funds to be raised, and bigger deals to be done. Such funds will be able to support more companies through multiple funding rounds, rather than seeking early exists through trade sales. This could a vital first move in creating the larger funds that can reinvest in multiple rounds, creating a new generation of growing UK companies.

The Fund

There are two options to deploy the capital in an EIS Fund.

(i) LP money from institutional investors could be raised alongside EIS money into a fund which would then invest into qualifying companies

Or

(ii) An EIS Fund could act as a fund of funds and invest in conventional VC funds provided they in turn would invest a percentage of their capital into qualifying companies. The fund could have for example, 3 years to invest in 70% qualifying EIS companies/funds (as in VCTs). Tax relief would be given at commitment rather than a deal by deal basis.

In order to achieve this, the following issues need to be resolved:

- EIS funds be allowed to make commitments to LP funds which make mostly VCT/EIS qualifying investments, rather than only invest directly in companies. A special EIS Limited Partnership could be set up for the purpose
- EIS funds, as part of the increase in company size and annual funding to £10m per company, are allowed to invest in similar instruments as typical LP funds (the BVCA standard term sheet)
- EIS funds are allowed to invest alongside LP funds in typical VC investments, and are also able to take a preferred return on their equity risk at the fund level.

2) <u>New Quoted VC Funds</u>

(i) We propose that the structure and governance that has been built up over the years with VCTs should be used in such a way as to open up venture funds to institutional investors, and in particular long term investors such as pension funds and charitable foundations.

This would greatly enlarge venture capital in the UK, creating broader and deeper portfolios and greater economies of scale.

(ii) There are currently approximately £2.8 billion of VCTs in issue. The great majority of these funds (around 80%) are permanent, evergreen funds where the proceeds of the sales of underlying investments are recycled into new opportunities. Some of the earliest VCTs, launched 15 years ago, are already on their third iteration of investment. Currently, VCTs raise £250-£350 million per annum; after taking into account losses and redemptions, this is just enough to keep the sector in equilibrium. But it is not growing.

(iii) It is the evergreen nature of VCTs that is their key attraction. This enables funds to invest for the very long term, and indeed technology investments increasingly require investment periods of 8 years or more before they finally mature. In addition, the experience of US venture successes show that, for technology investments, the best results can be obtained by backing an opportunity early, and then backing success through succeeding rounds over a period of many years.

(v) In order to make VCTs attractive to institutional investors, we would propose that institutional investors obtain tax relief of up to 30%, in a manner similar to the current provisions for private investors. However, unlike private investors, the institutions gain this relief through a tax credit on their other UK dividend income. Thus, for every £1 that an institutional investor in a VCT receives in the form of dividends from UK quoted companies, 10 pence may be claimed back from HMRC, up to a total level in aggregate of 30% of their investment in a VCT.

(vi) 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.

(vii) Under these measures, we believe that vehicles of an optimum size of around £100 million could be created with a beneficial mixture of UK institutional and private shareholders. We believe that this could ultimately double the size of the UK venture sector.

3) Credit Easing for VC Institutional Investment

(i) The Government could also reignite interest in venture capital from institutional investors as part of the current Credit Easing Programme. We believe that, if certain guarantees were offered for commitments to VC or SME funds, this could make them more attractive. It would also help offset the potential damage wrought by European Directives such as Basel III, Solvency II and IOPR, all of which discourage investment into real economy assets like SMEs.

(ii) State sponsored funds are now the biggest investors in UK and European venture capital at around 57%[2]. This is clearly not sustainable nor even desirable. Instead, the Government could use credit easing to increase the flow of investment from institutional funds.

[2] EVCA data

Alongside guarantees for small business loans, the Government could also guarantee a portion of investor commitment to venture capital – the funds would then flow through to start-ups and SMEs.

The current landscape discourages such commitments with capital requirements of up to 49% for unlisted equities. Loss relief could reduce capital requirements and release more capital for SMEs.

(iii) This could be run by a specialist vehicle run out of Capital for Enterprise. It could guarantee the first loss of say 20% of the value of the investment across a diversified portfolio of venture capital funds. This would limit the risk to the taxpayer. Such a scheme already operates in Denmark where the state guarantees a proportion of commitments into a specialist venture fund of funds with the rest of the capital going there as a direct equity investment. The fund of funds then distributes its capital to venture funds who in turn invest in SMEs. This encourages further commitments from pension funds because of reduced risk and without direct risk to the taxpayer, but also allows investors to use more manageable capital requirements (because the state guarantees the majority of the commitment) therefore diverting more money from sovereign bonds and into real economy assets.

Improving the attractions of AIM

AIM has been an important feature in the fostering of venture capital since the early 1990s. It has been a valuable source of venture exits as well as further financing, and of employee motivation through share option schemes. Sadly, however, this is no longer the case as investor appetite in SMEs has waned. We believe, therefore, that further measures need to be taken to reinvigorate the market.

First, we propose an increase in funding to growth companies by removing stamp duty from AIM shares. Stamp Duty is a direct cost to investors; it reduces liquidity and thereby raises the cost of capital for high tech companies alone by 13 per cent. Abolition would enhance the equity funding ladder by improving the ability of investors to sell their holdings at a reasonable return. KPMG have demonstrated that the measure would be revenue neutral in the long term as a result of higher economic growth following greater investment in business, and in the short term cost only 5 per cent of the total stamp duty revenues.

Second, we propose that the CGT regime for investment in quoted companies be relaxed in order to encourage investors to re-invest their gains into smaller companies. Introducing roll-over relief for capital gains on investment in companies on growth markets would not only boost liquidity but also encourage investors to re-invest their gains into smaller companies creating a more vibrant market for the longer term.

Entrepreneurs and their backers – tax incentives for start ups and SMEs

Improved targeting of EMI schemes, Entrepreneurs relief, and the general area of management incentives could, we believe, provide a major boost to the entrepreneurial culture the UK. We set out below our proposals for this area:

EMI Schemes

We share the Government's aim to promote greater employee share ownership to help foster a savings and investment culture. At present, private equity and venture capital backed companies are discouraged from offering shares and share options to their employees by the current tax system. For example private equity backed companies cannot issue share options under the Enterprise Management Incentive scheme nor get the corporation tax relief other UK companies would receive in the same situation on the issue of shares and /or the exercise of share options by their employees.

We propose:

- Tax rules are amended so that where a company issuing shares and/or share options to its employees is under the control of collective investment schemes, such as a private equity funds, EMI relief is made available
- Linkage of EMI to Entrepreneurs' Relief so that any shares acquired through qualifying EMI option exercise automatically qualify for ER – this would put employees who have committed to smaller holdings on the same CGT treatment as founders with larger holdings. It would also return those who have been option-holders for a significant period to the stated original position when they were granted i.e. at a 10% tax rate;
- Relaxing significantly the working time tests to allow non-execs and University academics to qualify; Increasing the upper limit per individual still further (to meet the needs of attracting incoming CEOs)

Entrepreneurs Relief

The Government's moves in this area have been significant and welcome. To complete this direction of travel, we propose:

- Removing the 5% holding test to allow smaller employee shareholders to qualify;
- Removing the employment requirement so that ER is deployed as an incentive to High Net Worth Individuals (HNWs). This is not just a point about capital. It is as much an issue of providing young companies with the experience and time that many HNWs can provide
- Increasing the cap to meet higher growth aspiration beyond £10m in a lifetime.

Management Incentives

We propose:

- Simplification of the whole regime for employee held shares and securities. The complexity of the current legislation is huge and takes away from the enterprise objective of employee share ownership. A commitment to move to a simpler regime and one where there is no question of tax charge prior to an employee being able to "enjoy" any monetary benefits from shares would be a significant step forward.

R and D tax credits

- We would like to emphasise the continuing importance of R and D tax credits to SMEs as a source of critical funding as well as encouragement to innovation. These tax credits have proved, over recent years, to be an excellent and well-targeted source of investment finance, and have had a material effect in improving the UK's technology base.

- We understand concerns that these credits should continue to be targeted at appropriate projects and activities, though we would urge caution to prevent any further targeting from being overly restrictive. We strongly welcomed the move in Budget 2011 to increase the rate to 225%.

Incentivising social investment through the tax system

Boston Consulting Group estimates that total social investment in 2010/11 was £165m[3]. Central government was identified as providing 50-60% of available funds, whereas only 5% of the investments made last year were categorised as equity or quasi-equity. This is an unsustainable model. To incentivise other investors to enter the market, amendments to the current tax framework will be necessary to create incentives for investment and catalyse the growth of the market. Suggested measures include:

- **EIS and VCT schemes:** EIS and VCT schemes have been effective at attracting investment into early stage high-tech companies and have evolved to become an important part of the UK's venture capital ecosystem. The Government should now look at amending the schemes to ensure that they are applicable to the social enterprise sector. It should look at removing restrictions such as the requirement that the investee company cannot be controlled by another company, which should be amended in the case of companies majority owned by a charity. For VCTs, Government should also look at lowering the minimum equity component in each qualifying investment if the investee company is a charity.

- **Community Investment Tax Relief (CITR):** the level and type of tax relief under CITR should be comparable with the relief available under EIS and VCT. The scheme should be broadened with qualifying definitions being made simpler and investment levels increased.

In addition, we would welcome the opportunity to discuss with Government how to incentivise more of the c.£100bn of capital held by trusts and foundations to be invested into social ventures.

Tech City

To help extend the 'Silicon Roundabout' cluster to incorporate the Olympic Site and delivery of the Government's Tech City initiative, we would advocate a co-investment fund for the area. Currently the Scottish Investment Bank manages a £72 million equity investment fund that invests from £100,000 to £1 million in company finance deals of up to £2 million. Investments are in partnership with private venture capital firms who source the deals and then attempt to secure matched funding from the SIB. A similar fund could operate on the Olympic site to drive the creation of a new community of start ups. It could

[3] The Boston Consulting Group, Young Foundation *Lighting the touchpaper.*

start at a modest £20m, investing up to a maximum of £250,000 per deal at no more than 50% of the total stake. Capital for Enterprise could be a suitable body for implementation.

2) The Competitiveness Dividend

With uncertainty in Europe and the rise of the BRICs, it is imperative that the UK takes a strategic view towards navigating our economy to a position of irrefutable global competeviness. In this way we can ensure that London is the finance and services capital of Emerging markets and the BRIC countries.

Private equity and venture capital businesses' ability to raise money internationally and invest in companies across the UK and Europe is determined by how competitive we are in a variety of areas. Headline tax rates, both personal and corporate will determine how much of global private equity and venture capital will be based here. So too will tax certainty. New regulations emanating from the EU not only increase compliance cost but they also cause huge uncertainty when institutional investors appraise our market and determine where to allocate their precious capital. Thirdly the business climate will determine how effectively we can make investments, grow businesses and realise returns for our investors.

Tax

We continue to support the downward trend in corporate taxation and the commitment to creating a culture of certainty and stability is the right approach. Capital Gains Tax remains high by international standards but again we welcome the commitment to retain the current regime for the life of this parliament.

Non-Doms

It is imperative that the taxpayer gets value for money from the non-dom community. Whilst they bring talent and expertise to the UK and help boost the competitiveness of our industry, they must pay their fair share. We understood the rationale behind increasing the annual charge for claiming non-dom tax status as well as welcoming the removal of the tax charge when non-domiciled individuals remit foreign income or capital gains to the UK for the purpose of commercial investment in UK businesses. However we remain concerned about the risks associated with this and therefore the uptake of the scheme. The need to guard against tax avoidance should remain paramount but unless the current provision is amended, a normal commercial event, which will be outside the control of the non-dom investor unless he has a majority stake in the business, could trigger a tax charge of up to 50% on the remitted funds which would be an unacceptable risk to participants.

Employment and Labour Markets

We start with the assumption that skilled migrants are welcome in the UK, particularly where they have capital and labour to invest in new businesses. It is not yet clear whether the Tier 1 entrepreneur's visa is working as it should. For example, if an entrepreneur has secured backing from a venture capitalist it will likely be in the form of debt or equity in their newly founded company – it will not be in the form of demonstrable ready cash in the individual's bank account. This should clearly not be a block on them gaining an entrepreneurs visa. Furthermore, funds have to come from the FSA Regulated entity but the FSA Regulated entity is not the fund – a small alteration enabling the funds to come from an entity *managed* by an FSA Regulated entity would solve this problem.

Employment law remains on constraint on the ability of businesses to boost productivity and create jobs. We fully endorse the Beecroft Report as a step in the right direction.

In particular, a "no fault" termination similar to that applied in the USA where notice is given under the employment contract would create a more efficient process as well as encouraging a more flexible and fluid workforce. It would have a material impact on the company's ability to accelerate operational performance and growth.

Protection to longstanding employees could be provided through an extension to the notice period. Research has demonstrated that change is as beneficial to individuals as well as for organisations.

We welcome the Government's initiative on Resolving Workplace Disputes and, in particular, the application of a rapid resolution scheme. In the interest of both the employee and the company it is important that a prompt assessment of the fact pattern is made to determine whether there is a valid claim followed by clear resolution process which removes uncertainty and cost for both parties.
In the interests of reaching a rapid a fair conclusion we would support the introduction of protected conversations with the proviso that they will not extend to protect discriminatory acts during the process.

Regulation

Domestically, we welcome the Government's focus on needless regulations that impact on UK businesses and the BVCA have submitted a separate response to the "Red Tape Challenge". Our principle concern remains regulation from the EU. The Alternative Investment Fund Managers Directive has created numerous new burdens on our industry's ability to raise funds and invest across Europe. Of note is its impact on smaller funds ability to engage in pan-European investment without opting in to onerous and needless provisions on capital and liquidity. There is now in train a separate regime for smaller funds and its viability will be key if we are to deliver the broader public policy objective of fostering greater venture capital in Europe.

Of equal concern is the Institutions for Occupational Requirement Provisions Directive (IORP). This would apply Solvency II standards to pension funds which has the potential to massively impair their ability to invest in real economy assets like venture capital and private equity. Pension funds currently represent around a quarter of our funding base so the economic impact would be significant. Across the EU, the general objective of all Member States' regulatory provisions is the safeguarding of pension beneficiaries' claims at reasonable cost. How this is achieved, however, differs widely across national regimes. Indeed, national social and labour law may determine the content of the pension promise, set minimum governance requirements, determine the level of sponsor commitment and provide insolvency protection. This is the right approach, as Member States should be given sufficient flexibility to put in place appropriate retirement systems that are reactive to the socio-economic circumstances, needs and desires of their citizenry as well as the employers that fund those schemes. We welcome the Government's continuing support in this area.

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