Financing growth in innovative firms

Role of Venture Capital Trusts

Identifying effective policy interventions to support smaller businesses, particularly innovative, entrepreneurial firms, will deliver significant public policy benefits, increase employment and productivity and sustain economic growth.

The government wants to ensure that investment is available for businesses which find it difficult to secure growth capital on suitable terms. Effectively responding to this challenge could unlock significant, additional growth potential across the UK.

The AIC welcomes the government's endorsement of listed closed-ended funds (investment companies) as a means to provide long-term capital to UK businesses. Investment companies pool capital from a wide range of institutional and retail investors. They offer investors liquidity, and diversification in the underlying portfolio, while also investing in unquoted assets. Alternative structures, such as open-ended funds, are less well suited to investment of this nature because they must maintain sufficient liquid assets (cash or traded securities) to allow them to meet investor demand for redemptions. In contrast, investment companies' can allocate funds to patient capital investments without being influenced by these considerations. They have no need to offer redemptions as their shares are traded between investors on a public market. The consultation raises issues relevant to the broader investment company community. These will be explored in a separate response. This response concentrates on issues relevant to the Venture Capital Trust (VCT) sector.

The objectives of the Patient Capital Review should be delivered by:

- **A range of interventions:** Different businesses have contrasting needs. They seek access to finance via different routes and from unique starting points. An effective policy intervention should recognise this by supporting a range of funding mechanisms.

- **Growth focus:** Supporting initiatives that can allocate funds for the long-term, with investment decisions driven solely by the commercial position of the portfolio business, should be central to the Government's approach. As important is ensuring that these interventions can identify and actively foster growth potential. The government should prioritise mechanisms with clear incentives to secure and encourage growth.

- **Sector neutrality:** The government wants to support enterprises that might deploy digital, scientific or other forms of technology to create new markets or transform existing ones. It should also recognise that innovation can take many different forms. It is very difficult to identify which investment propositions offer the best prospects of success. The government should not limit its support to certain sectors. Instead it should prioritise facilitating investment by a diverse population of long-term, growth orientated investors. It should introduce as few sectorial restrictions as possible which are consistent with this aim.

Venture Capital Trusts

VCT investment is targeted on smaller businesses. Shares in VCTs are overwhelmingly bought by retail investors. They receive tax advantages in return for allocating their savings to higher risk, less established businesses. The characteristics of VCTs make them ideal to raise capital, target smaller innovative business and provide sustained investment that actively promotes growth.

- **Patient, growth orientated capital:** VCTs take a long-term perspective on investing. Recent AIC research (Transforming small business, August 2017, page 14) showed that over half of VCT portfolio companies had benefited from VCT investment for more than five years. 20% of companies surveyed had received investment more than ten years ago. 6% of companies had been held within VCT portfolios for longer than 15 years.

  VCTs exemplify long-term 'patient' capital. They combine this perspective with a strong growth orientation. If a business can more swiftly develop to the next stage of its commercial potential, and can move to the next rung of the funding ladder (say, securing investment from traditional private equity investors or by making a public offer of its shares) VCTs are well placed to support this.

  VCTs provide expertise alongside capital. AIC research (Transforming small business, August 2017, page 10) found that 66% of companies had a representative of the VCT or its manager join the board. This oversight helps the business meet its commercial potential. Investments may also be conditional on the small business developing new internal processes, or the recruitment of additional senior management resources, to drive the business forward.

- **Young, innovative companies:** With certain exceptions, VCTs are now required to make their new investments into younger companies (under 7 years old). AIC research has found that 60% of companies receiving VCT finance since November 2015 have been under a year old. Over 90% were under seven years old (Transforming Small Business, page 8).

  As the case studies included in the AIC's report *Transforming Small Business* demonstrate, the profile of businesses supported by VCTs has increasingly involved the type of innovation which is such an important priority for the government.

- **Sector spread:** "*Financing growth in innovative firms*" considers the benefits of commercialising technology, for example, in relation to 'bioscience'. However, it also recognises that broader innovations, in terms of new products, processes and business models can deliver benefits and that they also need patient capital to secure growth. The paper rightly notes that patient capital is often sought by ambitious entrepreneurs who want to build large scale businesses.

  Not defining specific sectors as priorities for investment is a suitable strategy. Trying to identify 'winning' technologies increases the risk that opportunities will be missed, that an investment 'bubble' will be created, or government funds will be wasted. VCTs invest in a very broad range of sectors reflecting the diversity of commercial potential across the UK's small business sector.

Since 2015 the sectors most frequently invested in by VCTs have been "digital, creative and information services", "health" (which includes biotech/pharma) and "business services" (Transforming Small Businesses, page 9).

Notwithstanding the differences between companies supported by VCTs, a consistent factor is that they are characterised by ambitious management teams with the desire to grow a novel business model or product. This entrepreneurial drive is not limited to one sector or technology and VCTs are well placed to invest wherever opportunities arise.

- **Expert evaluation:** VCTs employ professional fund managers to seek out, assess and make investments. They draw upon a range of professional disciplines, including asset management, accountancy and legal skills as well as sector specific expertise (for example, in relation to healthcare or digital technology). Access to this breadth of experience is facilitated by the fund structure and the delegation arrangements characteristic of VCTs.

  While supporting individual entrepreneurs with their own networks and experience has benefits, VCTs provide a complementary and powerful mechanism to deliver finance to a broader range of businesses. They have economies of scale in areas such as legal and financial due diligence, because the external manager has established resources and systems that can be used for investments in more than one small company.

  VCTs operate within a wider ecosystem of advisers and investors (including business angels) which support their efforts to channel funds to companies that may not otherwise be able to secure growth capital. Many VCTs have links with serial entrepreneurs and academic institutions. These have been developed since the scheme's inception in 1995 and give VCTs a market presence which would not be easily replaceable.

  These mechanisms allow VCTs to identify smaller cash-poor companies with the potential to grow. As importantly, it allows them to screen out propositions that, even with a capital investment, do not have a realistic business model. This helps ensure Government resources are deployed wisely.

- **Mobilising an otherwise untapped source of capital:** The tax relief provided via VCTs encourages ordinary retail investors to invest in VCTs. HMRC analysis found that "*The majority of VCT investors tend to invest smaller amounts into VCT funds. In 2014-15, 44% of investors made a claim for an investment of £10,000 or less and only 7% invested above £100,000*" (HMRC. Venture Capital Trusts Statistics December 2016 Table 8.9. page 5). These investors are likely to have satisfied many of their basic savings needs but are not all very high earners.

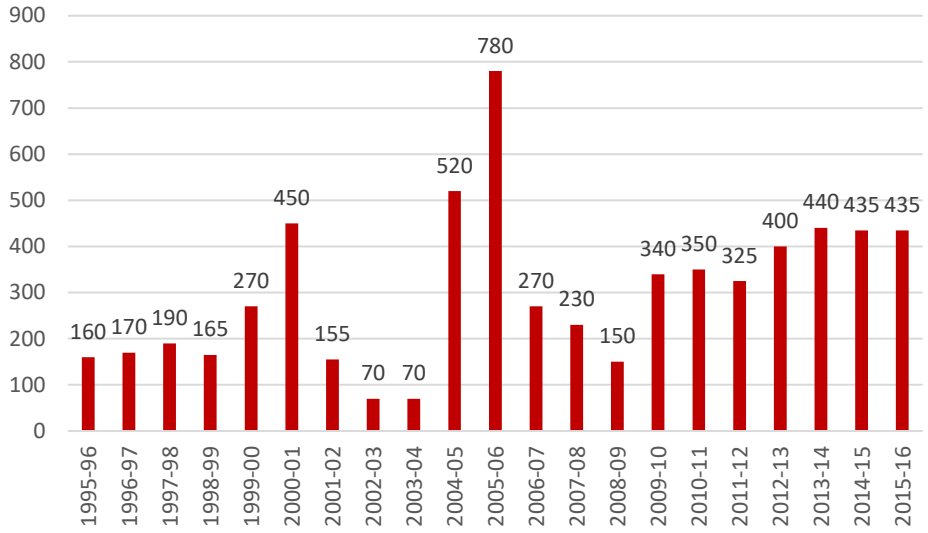
  The VCT scheme offers investment opportunities that are not available, or suitable, without the diversification offered by the fund structure, access to expert fund management and risk offsetting provided by the tax reliefs. They offer the chance for many investors, who would otherwise be excluded from this market, to take a stake in entrepreneurial businesses.

  Much of the capital pooled via VCTs is truly additional. It would not have been invested without the reliefs, particularly the initial 30% income tax relief. The same may not be true

where measures relieve tax paid on gains from investment on the 'way out'. That is, on the proceeds of a disposal.

The fundraising history of VCTs indicates very strongly that the initial income tax relief is critical to mobilising retail investment.

Amount of funds raised by VCTs (Source: HMRC. VCT statistics. October 2016)



Investors received a 20% rate of initial income tax relief when the scheme was created in 1995/6. This saw modest amounts raised, typically under £200million. There was an increase during broader market enthusiasm for internet-related investments at the turn of the millennium, but this was short lived. Fundraising saw a sharp downturn following the broader market crash that followed. Levels of fundraising increased sharply when the initial income tax relief was increased to 40% in 2004/5 and 2005/6. Amounts raised by the sector were reduced once the rate was adjusted to 30% thereafter.

While other factors, such as broader market sentiment and, more recently, limits in the amounts of pension contributions, have had an impact on the appetite for VCT investment, the primary driver of VCT fundraising has been the level of the initial income tax relief offered. It is less clear that investors who directly set up and build businesses would not invest if they did not receive additional tax reliefs. The same is not the case for most retail investors in VCTs.

- **Leveraging capital:** Attracting a different cohort of investors to the small, unquoted business sector increases the importance of the leverage provided by the VCT tax reliefs. The 30% rate attracts a further 70% of private money to growth companies that otherwise would not be available.

- **Follow-on funding:** The government is concerned that smaller businesses can struggle to secure further rounds of growth finance following an initial investment. Providing successive rounds of growth orientated investment is important to the success of many smaller innovative businesses.

  The prospect of receiving follow-on funding creates incentives for the smaller company to deliver agreed business objectives to trigger the provision of further capital. Agreeing these milestones at the time of investment and then implementing systems to monitor and measure how the business is performing creates a virtuous feedback loop that can drive business growth. The process embeds positive business disciplines and helps ensure that growth capital is allocated effectively. The processes surrounding the provision of follow-on investment also provide information that can be used to attract external fund-raising from other sources (such as a bank, private equity fund or other investor). Meeting agreed milestones demonstrates how a business is progressing and helps prepare it for further external investment.

  AIC research (Transforming small business, August 2017, page 15) has found that a substantial proportion of VCT portfolio companies have received one or more rounds of investment. Excluding companies that have been held less than 3 years (which are less likely to have exhausted any initial finance or reached relevant milestones) 60% of investee businesses surveyed have received more than one round of investment. 44% had received more than two. 31% received more than three and 21% received more than four rounds of investment.

- **Enabling access to public markets:** The UK stock markets provide various options for companies to secure growth funding. These operate under a variety of regulatory standards: shares can be admitted to a full (premium) listing, a secondary listing or can trade on an unregulated market, notably the Alternative Investment Market (AIM). Each market is suitable for companies at a different stage in their development, AIM being an important option for companies with less established track records but which still see advantages in a public share issue.

  VCTs can subscribe for AIM shares. They can be critical to the success of initial public offerings (IPOs) on AIM as they are often among the earliest prospective investors to consider proposals in detail and, where the company meets their investment needs, make early commitments. They act as cornerstone investors; providing significant amounts of capital which helps the company to meet its fundraising targets (making the IPO cost-effective) and building confidence among other potential investors.

  VCTs continue to play this role for companies seeking admission of their shares to AIM. Their involvement can be critical in the success of such activity. For examples of recent VCT investments of this nature see Transforming Small Business, Velocity Composites page 13, Creo Medical page 17, FreeAgent page 19, ECSC page 23.

- **Supporting access to other sources of external capital:** Once a VCT has invested, smaller companies often find it easier to access traditional sources of finance, such as banks. VCT investment demonstrates confidence in the commercial potential of a small business. VCTs often impose a higher level of financial discipline on entrepreneurial businesses which might otherwise be lacking. Their involvement also helps develop

business planning and other processes which make it easier for other investors to commit capital once the VCT has acted as a 'pathfinder'.

- **Offering a funding package:** VCTs' ability to blend a combination of equity and debt can be particularly attractive to entrepreneurs who can be unwilling to give up significant amounts of equity. This may be particularly the case where VCTs are providing later stage investing and the owner has previously received equity investment from other sources such as business angels and other EIS investors.

  VCTs can design a 'package' of investment, with tailored interest rates, covenants, and other commercial terms, based on a combination of loan and equity provision. This enables them to match the needs of the VCT with a very broad range of smaller businesses with different commercial prospects and at different stages of their development. Critically, the ability to offer a broad range of funding packages is facilitated by the flexibility allowed by the current VCT rules.

- **Geographic reach:** The VCT sector has evolved into a national network. One concern identified by the government is a propensity for early stage investment to be focussed on London and the South East. It is not surprising that significant investment opportunities arise in these areas because of the overall distribution of economic activity within the UK. Nonetheless, it is also important that other regions are not denied a sufficient supply of early stage capital.

  Historically, the VCT scheme has successfully invested across the UK. AIC research (Transforming Small Business, page 18) found that just over half of companies currently within VCT portfolios were in London and the South East. However, other regions also secured significant interest. Eight percent were located in Scotland. 14% in the North (including the North East, North West and Yorkshire and the Humber). The rest of the UK accounted for 25% of the companies held.

  Recent investment has followed a similar pattern. Since November 2015, seven percent of investments have been in Scotland. 21% of companies were in the North. 16% were in the rest of the UK. Companies based in London and the South East combined made up the last 56% of investments (Transforming Small Business, page 9).

- **Governance and transparency:** VCTs have independent boards with legal duties to operate the company in the long-term interests of the shareholders. Directors are focused on ensuring that the investment mandate is delivered. This oversight creates strong incentives for managers to identify investments most likely to succeed and work with small businesses to keep them 'on track' where commercial expectations are not being achieved.

  VCTs are very transparent. They must make disclosures to shareholders and the broader market. These include publishing an annual report and accounts and making timely disclosures of information likely to inform the VCT's own share price (for example, if investments or divestments are made).

  These mechanisms provide the basis for efficient investment practices and accountability to the shareholder and wider public interest.

- **Value for money:** VCTs provide investment to a wide range of smaller growth orientated businesses, creating higher turnover, jobs, exports and supporting R&D. Portfolio companies pay higher levels of tax than they otherwise would, helping to offset the cost of the government's investment (see Transforming Small Business, page 28).

  The structure also delivers value for money as it allows capital raised to be reinvested, which significantly reduces the exchequer costs. While the rules only require investment of up to 70% of VCT funds in qualifying holdings, longer established VCTs can achieve significantly higher levels of investment, with some achieving investment in qualifying holdings of over 100% of the original funds raised.

Notwithstanding the important benefits offered by the VCT structure, the AIC understands that certain investment practices by tax incentivised schemes, including the Enterprise Investment Scheme (EIS), do not fit with the government's current priorities. The government is seeking views on rule changes to address these matters. The proposals below address these issues and reinforce the case for continued government support for the VCT scheme.

AIC approach

The AIC's recommendations will achieve the following outcomes:

- ensure that VCTs can continue to invest in innovative, small businesses, based across the UK in the widest number of sectors;
- address government concerns about certain current investment practice by EIS and VCTs;
- ensure that future tax reliefs provided to EIS and VCTs continue to support investment that meets the government's policy aims;
- increase the cost-effectiveness of the VCT scheme;
- facilitate the efficient delivery of capital to businesses seeking VCT investment;
- deliver these outcomes in a robust and sustainable way, which minimises any need for further adjustments to the rules applying to EIS and VCTs;
- minimise arbitrage opportunities between VCTs and EIS, which might otherwise allow less desirable practice to shift between the schemes to exploit gaps in the rules.

Effectively targeting EIS and VCT investments

The government is a key stakeholder in the EIS and VCT schemes. It is essential that any reservations it has about the targeting of investments made under these schemes are fully addressed. The AIC **recommends** that any measures taken to refocus VCT investment are also applied, where appropriate, to the EIS. (For the purposes of this paper, references to EIS should be taken to include Seed EIS, where appropriate).

Overall approach

The AIC has considered options to create a positive definition of 'innovation' to ensure the VCT and EIS schemes are targeted effectively. While this approach has attractions in theory, it is very difficult to see how this would be achieved in legislation without creating too narrow a focus of eligible businesses. For example, requiring investments to be targeted on businesses that meet, say, the R&D tax credit or 'knowledge intensive' business requirements (or variations on them) is likely to have limited success. It is more likely to be damaging to the UK's growth potential.

Trying to create a positive definition of innovation would exclude many businesses that could be important sources of innovation because they did not meet the government's identified criteria. By its nature, innovation is likely to be unpredictable. Innovation involves applying information, imagination and initiative to get more value for a business from its available resources. It can encompass any processes that converts ideas into new products or services. Critically, the success of business innovation is only apparent when an organisation successfully provides its products to customers. This process is unlikely to flourish where the opportunities for businesses to receive capital to support innovation are limited by legislation trying to actively direct investment into certain areas. Successful support for innovation is more likely to be delivered by allowing a wide variety of businesses to be supported where the market identifies that they have growth potential.

To ensure the scheme is well targeted the AIC **recommends** that the legislation should clearly define, and prevent, activities which cause concern. Targeting should not be achieved by defining what type of commercial activity should be supported.

This will also maximise opportunities for VCTs to support other positive outcomes, such as economic growth and job creation, where smaller businesses need finance and represent a high-risk investment opportunity.

Excluded activities

Simply extending the list of excluded activities is not sufficient to address all the government's concerns. It would risk creating an environment where new exclusions are continually introduced to tackle government concerns. That said, this mechanism can act as an important 'backstop'. Other recommendations below should prevent problematic investment activity arising in the first place. However, notwithstanding the government's best efforts, there may be situations in the future where problems do arise and extending the list of excluded activities would allow the government to respond quickly where remedies adopted do not effectively 'future proof' the rules. To facilitate this, the AIC **recommends** that the government should take enabling powers to extend the excluded activities list using secondary legislation. This will remove the need for measures to be introduced via the Finance Bill, which might otherwise act as a constraint on swift action.

The AIC understands that investment in film and television production represents a concern for the government. If the government concludes that it is difficult to exclude poorly targeted investment in these areas using a more 'principles based' approach, the AIC **recommends** that television and film production should be added to the excluded activities list.

'Grandfathered' capital

In the past, new investment restrictions have tended to apply to new funds raised. This practice has protected shareholders in VCTs with a certain set of expectations over the nature of their investment. There was a significant change in November 2015, when additional investment requirements were applied to all new investments (irrespective of when the funds were raised). This has successfully refocussed much VCT investment on the government's current policy priorities.

However, previous 'grandfathering' provisions mean that some VCTs have pools of capital that can be allocated to activities that cannot be funded by newly raised capital.

The AIC **recommends** that grandfathering for excluded trades be ended for new investments.

Capital preservation

Several investment practices, broadly described as 'capital preservation' mechanisms, are a concern to the government. This includes 'asset backed' investments. We understand that it is not the holding of assets themselves which is the concern (after all, all businesses need assets to operate): it is the extent to which these assets can help reduce the risk of EIS or VCT investments.

The growth and development test provides the basis for ensuring that EIS and VCT investment is used to fund expansion and new commercial activity. It operates successfully in many situations to prevent 'capital preservation' activity. Also, the disqualifying purpose provisions could be used to help exclude other problematic arrangements.

The AIC understands that investments in property (including freehold and long leaseholds) have been a cause of concern. The AIC **recommends** that investments in property using funds provided by an EIS or VCT be prevented.

The AIC also **recommends** that legislation be introduced to prevent new VCT and EIS qualifying investments be made in companies that subcontract the management of the company's general trade and operations at more than 50% of its costs.

Cost-effectiveness

Recycling VCT investment

The rules require VCTs to invest up to 70% of their funds in qualifying holdings. However, longer established VCTs can achieve significantly higher levels of investment, potentially over 100% of the original funds raised. The AIC **recommends** that rule changes should be introduced to make recycling of VCT capital easier. This would further enhance the level of VCT qualifying investments.

Currently, the proceeds of investment must be reinvested in qualifying holdings (in sufficient amounts to ensure the VCT meets the 70% qualifying holding test) within 6 months. If this

period were lengthened, this would create more opportunities for reinvestment and increase the potential cost-effectiveness of the VCT scheme.

There is no cost to the taxpayer of extending the time-period as, if the proceeds are distributed, they are not taxed when received by the investor. The current restrictions on non-qualifying investments will protect the government from any risk that funds would not be used to deliver government objectives.

The AIC **recommends** that the current six-month period (where the proceeds of realisations of qualifying investments are not included in the calculation of the qualifying investment threshold) be extended to 12 months.

Another 'hangover' from the investment trust rules is the retention test. It increases complexity and creates an obligation to distribute returns rather than reinvest. These rules prevent a VCT from retaining more than 15% of any income received. This requirement is relevant in the investment trust context because it stops income being converted into capital. If this practice was not controlled, it could provide options to inappropriately reduce the tax paid by investors. This is not relevant in the VCT context as investors are not taxed on capital gains or dividends. The AIC **recommends** that the retention requirement be removed.

Overall costs of tax incentivised investment

The overall cost of government policy designed to support smaller growing businesses is likely to be under consideration. The government has also indicated that its resources may be reallocated from existing schemes to new interventions (such as any initiative to replace European Investment Funds).

The AIC **recommends** that any measures of this nature do not change the level of tax relief received by VCTs. In particular, the AIC **recommends** that the initial income tax relief is not adjusted. As discussed above, the initial income tax relief rate is an important influence on the level of funds raised by the VCT scheme. Reducing the initial income tax relief would substantially reduce funds available to VCTs. This would compromise the government's ability to achieve its ambitions for the patient capital review.

The government's efforts will be less able to benefit from the very positive characteristics of VCTs identified in the first section of this paper. New initiatives will not be able to replicate these benefits, which are unique to the scheme and/or have been accrued over many years of activity and experience. The recommendations on investment practice set out above will ensure that VCTs are even more focussed on the government's priorities. They will also support more effective deployment of funds to the type of businesses that the government wants to provide support for.

The AIC nonetheless recognises that the government might want to moderate the amount that an individual can invest via the VCT and EIS schemes. These two schemes are complementary and operate under very similar investment rules and incentives. They differ slightly in their construction because they serve slightly different markets. EIS, for example, can serve angel investors with an interest in investing in a specific business. VCTs take a fund approach, offer liquidity to investors because their shares can be traded on the stock

market and therefore have a broader appeal to a far wider range of potential purchasers. They can also invest in slightly later stage businesses, provide follow on funding and access capital that EIS is less able to mobilise.

The AIC's preference would be not to adjust the reliefs currently available to either scheme. However, if the government is seeking to reduce the level of taxpayer resources provided via these initiatives, the AIC **recommends** that the government consider allowing investors an annual amount, for example £500,000, which individuals can invest either in VCTs or EIS or a combination of the two.

This would help manage the overall cost of the schemes without creating any wider negative consequences. It would reduce any arbitrage opportunities and maximise incentives for investors to allocate funds according to the investment case for each vehicle, rather than the level of the initial tax relief.

Facilitating investment

To maximise the positive impact of VCT investment, the AIC **recommends** that HM Treasury should also prioritise steps to facilitate the effective deployment of capital.

Removing the 'cliff edge'

One factor which significantly complicates, and potentially lengthens, the investment process is the risk of making a non-qualifying investment. If a VCT makes one error, which results in a non-qualifying investment being made, the VCT risks losing its tax status. This would have very serious consequences for the company and its investors. The potential for such a catastrophic outcome, for what might be a relatively small error, has resulted in VCTs adopting due diligence processes (including, invariably, requests for advance assurance from HMRC) which are expensive and time consuming. These administrative and due diligence burdens could be alleviated by removing the 'cliff edge' consequences of making a non-qualifying investment because of a genuine error. The AIC **recommends** that the rules be revised so that, in these circumstances, the VCT does not lose status. Instead it should be required to remedy the breach, for example, by making a disposal of the relevant investment or some other mechanism.

Reducing uncertainty in interpretation

Interpreting some of the VCT investment requirements involves considerable judgement. This includes, for example, assessing whether a proposed investment is supporting entry into a 'new' geographic or product market. The rules allow an investee company to have made some 'test sales' into markets without precluding that market being 'new'. This is a difficult area.

This uncertainty could be reduced by providing a 'safe harbour' whereby any sales below certain thresholds would be considered not to represent prior entry into a product or geographic market. The AIC **recommends** that this should involve setting a threshold based on either a small number of unit sales (which would be appropriate for larger value items) or (alternatively) the value of sales (which would be appropriate for smaller value items, such as

consumer goods). Where activity falls below either of these thresholds then it can be considered to be a 'test sale' and not represent entering a new product or geographic market. The AIC **recommends** that the 'unit' number should be (at least) 6 units and the sales value should be (at least) £250,000.

Facilitating follow-on investment

The government has identified the benefits of providing successive rounds of growth capital. VCTs are well-suited to this activity. The current interpretation of the VCT rules restricts follow-on investments because there is an expectation that follow-on investment is provided to support the same activity as the initial investment. Entrepreneurial businesses' plans, and funding needs, by their very nature, evolve over time. Investors funding growth and innovation would normally expect to provide capital to the 'business' rather than identifying discrete areas of activity. Determining whether a commercial activity is a continuation of earlier one or a novel initiative is very complicated. The current interpretation of the requirements for follow on investment creates uncertainty and substantially increases the amount of discretion within the rules on follow-on funding.

The AIC **recommends** that the interpretation of the follow-on requirements be modified so that not all capital provided via a follow-on investment is required to be used to support the same activity as the initial investment. Instead the approach should require that some follow-on funds are used for the same purposes. The proportion of funds that must be deployed on the original activity would depend on circumstances of the investee company.

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