Venture capital market

Treasury select committee submission

Venture capital trusts (VCTs) are a unique, and a growing part of the UK's venture capital ecosystem. VCTs invest in smaller, entrepreneurial companies facing a finance gap. That is, small businesses which struggle to raise capital from traditional sources, such as banks and mainstream investment funds.

Since 2018, VCTs have invested £1.7 billion into 532 different small and medium size enterprises (SMEs). This represents significant support for companies facing a finance gap.

This finance gap is a persistent problem because smaller businesses' capital requirements are small in comparison with other private-equity type investments. This makes it proportionally more expensive to invest in them as the pre-investment due diligence requirements are similar to larger investment opportunities. Both require specialist expertise, time, and resources. Investment in SMEs also involves additional investment risk as these companies do not have the same track record, or offer the same collateral, as their more established counterparts. For these reasons, banks, and other private equity investors, do not tend to invest in the smaller businesses targeted by VCTs.

VCTs therefore address a significant market failure. They are an important rung on the funding ladder: one step higher than the earliest stage investors, such as family, friends, and business angels. They provide a step up to equity provision by larger private equity investors, trade buyers or a stock market flotation. They offer essential support for the small business community and contribute to the overall vibrancy of the UK's venture capital market. It is SMEs, not large established companies, that fuel economic growth and job creation. Supporting these companies is fundamental to the success of the UK economy.

So that VCTs can play this role in the venture capital ecosystem, retail investors in VCTs receive tax incentives to encourage them to allocate their savings to the sector. This government support helps offset the higher costs, and additional risk, of investing in SMEs. VCTs mobilise this capital to support entrepreneurs that want to grow their businesses: in turn developing new products and services and creating jobs. (Annexes discussing VCT support for UK SMEs and VCT rules and options for reform are attached.)

A key issue facing the VCT sector is a 'sunset clause' which, without government action, will end key investment incentives for retail investors in 2025. This would take hundreds of millions of pounds out of the market, which will no longer be invested in SMEs. This issue is explored in more detail in this submission.

The AIC **recommends** that the Treasury Select Committee endorses the removal of the VCT sunset clause and encourages HM Treasury to make an early statement about its intentions in this area.

The Association of Investment Companies (AIC)

The AIC represents listed, closed-ended investment companies. That is, collective investment vehicles, structured as companies, with an independent board of directors. Buying and selling investment company shares on the stock market gives investors reliable, daily liquidity, irrespective of the underlying assets. These characteristics have allowed the sector to diversify into a wide range of private assets, including private equity and growth and development capital. The AIC's members include VCTs.

VCTs have £6.5 billion of assets under management. The AIC represents 44 VCTs, which hold over 95% of the sector's assets under management. VCTs typically employ specialist asset managers, who deploy their capital and perform other day-to-day activities necessary for the running of the company.

The VCT's board provides an important layer of governance. It oversees the manager and makes sure its services are discharged in the best interests of shareholders and the company. The board ensures that systems and controls are in place so that the company maintains its tax status as a VCT.

A unique source of capital and support for growth companies

VCTs create an additional pool of capital to support SMEs because their newly issued shares are bought by retail investors who would lack the capacity to invest via another route. These investors tend not to be experienced in SME investments and lack the resources to buy into these businesses directly. Subscribing for VCT shares means the retail investor benefits from the expertise of specialist fund managers who identify opportunities and negotiate the deal on behalf of the VCT. They gain exposure to a diversified portfolio, which helps manage the risk inherent in holding smaller companies. The external manager also provides ongoing monitoring and oversight of companies within the portfolio.

VCTs have some similarities to the Enterprise Investment Scheme (EIS). Investors in both schemes receive attractive tax incentives to provide growth capital to SMEs. However, VCTs and EIS investments differ in significant respects. VCTs' fund structure allows them to maintain a pool of capital for further rounds of investment after the initial injection of capital into an SME. This can be very helpful where the SME has a continuing need for external finance to deliver its business plan. These requirements are particularly likely for SMEs developing innovative technologies.

VCTs are often better placed than EIS investors to provide larger amounts of development capital over an extended period. This capacity can be attractive for entrepreneurs where it reduces the amount of time and resources they have to devote to fundraising; an activity which is, in any event, inherently challenging for smaller businesses.

Unlike EISs, VCTs can offer SMEs a mix of equity and debt financing. Generally speaking, a VCT must hold at least 10% of its investment in an SME in equity. Overall, a VCT's portfolio of SME investments must be at least 70% in equity. This framework allows VCTs to tailor transactions to fit the needs of individual SMEs. They can accommodate the differing appetites or ability of entrepreneurs to sell equity, allowing them to satisfy the funding needs of a wide range of SMEs at different stages of their commercial development.

VCTs also provide a source of commercial discipline for the SME itself. Their investment processes involve setting targets to be met before further rounds of funding will be provided. Investments may be conditional on making changes to the business, such as recruiting new management capacity or imposing more sophisticated financial controls. Transactions may involve the appointment of a representative of the VCT to the board of the SME. The appointment of directors can provide support to management and oversight of the progress of the business. VCTs and their managers may also provide advice on specialist recruitment. This can be particularly valuable for SMEs with a technology focus that are seeking to rapidly expand their staff numbers. These activities supplement the provision of capital to create the strongest possible basis for achieving the goals set out in the SME's business plan. This discipline, and provision of successive rounds of funding, make VCTs a powerful engine for SME growth.

While they are long-term providers of development capital, VCTs also consider how they can help an SME move onto the next rung of the finance ladder. They help the SME's management make long-term plans for growth, whether this involves attracting funds from larger private investors, listing the business on a stock market or other ways to continue the business' commercial success. Where SMEs take these steps, they provide options for the VCT to sell its own interest in the company and use the resulting funds to support the continued activity of the VCT, including making further investments in other SMEs.

The role of commercial incentives

The VCT structure incorporates commercial incentives which increase the likelihood of the investee company's success and minimise waste of government resources (deadweight costs). VCTs and their asset managers compete for investment funds. VCTs with a history of making successful investments are better able to attract funds and sustain a long-term market presence. VCTs with less successful records leave the market. Some change their external investment manager or wind up. Market discipline and competition has been central to the evolution of the sector.

These same market forces have reduced the likelihood that investments by VCTs are made into SMEs without a prospect of success. The independent board of each VCT has a duty to secure the best return for the company's own shareholders in line with the investment policy and the requirements of the tax rules. The external manager has incentives to support SMEs that are most likely to be successful. This will allow them to grow their own fee revenues via increased asset values and through attracting additional investment capital. Their fee structures often include performance fees to sharpen the incentive to deliver successful investments.

These incentives create a virtuous cycle, which benefits SMEs seeking funds, delivers the government's objective to support access to capital and generates returns for investors. They create an environment where the government's 'contribution' is invested alongside the savings of private investors with very strong interests in robust and successful investment processes.

The fund structure itself also supports the government's public policy objectives. Holding a portfolio of SME investments helps spread investment risks and provides the basis for the VCT to build and maintain a reservoir of investment expertise. Expertise, sustained over time, allows investment opportunities to be identified and scrutinised more effectively, to the benefit of the VCT and the public purse.

These processes do not guarantee that VCT-backed SMEs will succeed. Failure is part and parcel of making risk-based investments. However, the commercial processes embedded in VCTs reduce this possibility in comparison with approaches which simply rely on government grants or other centralised mechanisms. This commercial and competitive ecosystem has developed over the last 25 years and is an important component of the VCT approach which cannot be replicated by other policy interventions.

VCT sunset clause

The VCT rules have evolved over time to meet government objectives and the requirements of EU State aid rules. In an ideal situation, there would be opportunities to evolve them further to ensure they remain relevant and effective. That said, the VCT scheme is working effectively. VCT investment is very focussed on SMEs facing a finance gap. HM Treasury may therefore have more pressing priorities than reforming the VCT rules. While there are changes which could be made in the longer term to secure the best possible outcome for all VCT stakeholders, the AIC's primary concern is to ensure that VCTs can continue to operate on the current basis. This objective is affected by the existence of a 'sunset clause' included in the VCT tax legislation.

The VCT scheme was approved as a State aid by the European Commission in 2015. This approval expires on 5 April 2025. If the sunset clause is not removed from the Income Tax Act 2007 (as amended), then subscribers for new shares after that date will no longer be eligible for the 30% initial income tax relief. (Note, investors who hold VCT shares issued on or after that date may still be eligible for the tax relief on capital gains and dividends.)

The removal of the 30% income tax relief will remove a necessary incentive for retail investors to subscribe for VCT shares. This will create fundamental challenges to the sector. New share issuance after the triggering of the sunset clause would collapse, meaning VCTs can no longer raise additional funds for further investment in SMEs. Early action to remove the sunset clause is needed to ensure the continued success and vitality of VCTs as an investment vehicle and a means to deliver the government's funding priorities for UK SMEs.

The sunset clause was imposed to secure EU State aid approval. Such clauses are not typical of the UK's legislative approach. The finance gap is not a temporary feature of the UK's small business finance environment. The value of VCTs in addressing this permanent market failure is not temporary. Continuing the VCT scheme should be a government priority.

Removing the sunset clause requires a simple technical adjustment to legislation. It could be achieved by either an amendment deleting the relevant clause or by using secondary legislation to change the date. However, there are other practical and political challenges involved in removing the sunset clause because of continued oversight of the VCT scheme by the European Commission. This arises from the application of the Northern Ireland Protocol. The current legal framework includes Northern Ireland in the EU's single market. This means that changes to the VCT scheme, including deleting, or otherwise adjusting, the sunset clause, require the approval of the European Commission. This complicates the question of addressing the clause.

The AIC does not have a position on the future of the Northern Ireland Protocol and its impact on the UK subsidy regime. Nor does it have a view on the future political and legal arrangements which should be applied in relation to Northern Ireland.

The AIC expects that, given the persistence of the finance gap that VCTs address and the success of VCTs in investing in target SMEs, HM Treasury will take steps in due course to mitigate the impact of the sunset clause. In this context, and assuming no change to the current application of the Northern Ireland Protocol, there are two ways in which addressing the sunset clause could be approached:

- **Re-notifying the scheme to the European Commission for State aid approval:** This would involve an administrative process. It would include supplying information to the European Commission on the impact of the scheme. This is not a problem in principle.

  VCTs are a suitable and effective mechanism to address the finance gap for SMEs. This was recognised in the 2015 State aid approval from the European Commission. The market failure VCTs address still exists. This would have to be evidenced when approaching the European Commission. The need for VCTs to demonstrate their continued value is not unique to the State aid process. HM Treasury keeps the scheme under review and the process of providing evidence to secure State aid approval would support the government's own processes for monitoring the impact of VCTs.

  One downside of approaching the European Commission for State aid approval is that operating within the EU State aid framework will limit the ability of the UK to modify the VCT rules according to its own policy preferences. The AIC is not currently proposing changes to the scope of the VCT scheme, although there are areas where the rules could be improved. For example, a VCT inadvertently making a non-compliant investment could lose its tax status. There should be a mechanism to prevent, remedy, and potentially, sanction such investments. Losing status because of one inadvertent error is a disproportionate penalty and managing this risk increases compliance costs. Other technical changes could be made to the VCT rules to create a more proportionate compliance burden. (See Annex: VCT rules and options for reform.)

  The AIC's priority is to prevent the triggering of the sunset clause. This is more important than refining the rules to make incremental gains. However, were the UK to address these issues in the future, the process of State aid approval will make this more challenging. The European Commission may not have the appetite to adjust rules, particularly those it considers essential to securing its own State aid rules. This position may contrast with the UK government, which has its own approach to subsidy control. The European Commission may be most reluctant to changing the definition of qualifying investments. The previous process of State aid approval indicates that even relatively technical changes may be difficult to negotiate.

  Also, it is likely that the European Commission would time limit State aid approval. This would mean the process of reapplying for approval would have to be repeated in the future.

- **Exclude Northern Ireland SMEs from VCT qualifying investments:** This would be intended to remove the VCT scheme from oversight by the European Commission as VCT activity would no longer create a risk of distorting trade within the EU single market. Under this approach, the VCT scheme would be governed by domestic authorities. This option has wider political ramifications as it affects the political debate over the status of Northern Ireland within the UK.

Were this approach to be taken, the AIC **recommends** that the UK introduce a successor scheme for financing SMEs in Northern Ireland. This approach would create a specific source of investment funds, targeting SMEs within Northern Ireland.

Current VCT investment in Northern Ireland is limited. Since the start of 2018 (the last time the VCT investment rules were recalibrated), data indicates that only three SMEs based in Northern Ireland have received investment from VCTs. The total amount received was just £10.5 million. This suggests that excluding SMEs based in Northern Ireland would not create a significant disruption to flows of development capital within Northern Ireland.

Establishing a dedicated Northern Ireland scheme may offer new opportunities to mobilise capital for this part of the market. Depending on the size and design of the scheme introduced to replace VCTs, it might be easier to negotiate State aid approval for a targeted approach with the European authorities. Northern Ireland is within the EU's Regional aid Guidelines framework. These set out the rules governing state support to the least favoured regions of the single market. The intention is to allow these regions to 'catch up' and to reduce disparities in terms of economic well-being, income, and unemployment. These rules increase the possibilities for the provision of aid to enhance regional development.

Were the sunset clause to be addressed using this approach, the UK could subsequently adjust the VCT scheme rules in accordance with its own policy priorities.

Given the broader Northern Ireland context, the political attraction of this approach may depend on the UK's desire to assume control of its subsidy arrangements balanced against its appetite to maintain an approach which covers the whole of the UK.

The AIC has no fundamental preference for either route. It simply notes that each route raises different policy issues and that, whichever approach is taken, the priority is to resolve the sunset clause in advance of the 5 April 2025 deadline. The AIC **recommends** that the Treasury Select Committee endorses the removal of the VCT sunset clause and encourages HM Treasury to make an early statement about its intentions in this area.

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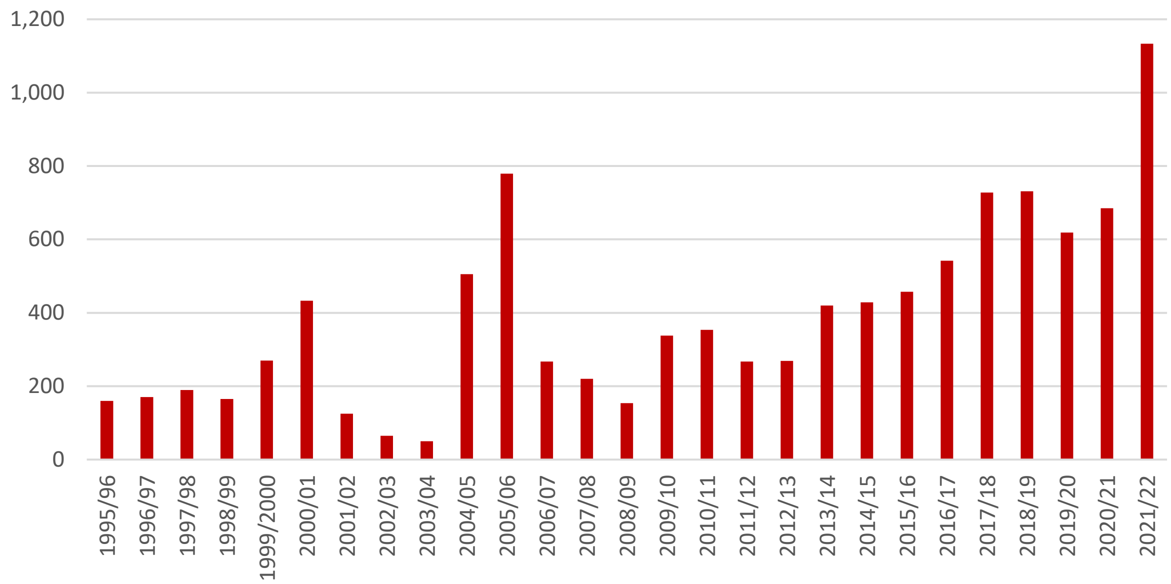
Annex: VCT support for UK SMEs

VCTs are successfully mobilising funds for investment and targeting these funds on SMEs facing a finance gap.

Mobilising funds for investment

The tax reliefs have been effective at encouraging retail investment in SMEs via VCTs.

Fig 1: VCT fundraising (£ millions/tax year)



The sector is widely recognised as a way to invest in potentially higher growth SMEs. As confidence in the scheme has developed so too have levels of investment increased. Other factors, such as limits on the amounts which retail investors can hold in pensions, have also increased the attractions of VCTs.

Fig 1 illustrates how fundraising fell after the economic implications of Covid-19 emerged. Even so, fundraising in 2019/20 remained high in comparison with the overall history of the scheme. It has since recovered, with this year seeing a record of £1.13 billion raised for further investments into UK SMEs.

The previous historic high fund-raising period (in 2005/6) was stimulated by an increase in the initial income tax relief to 40% (up from 20%). This demonstrates the power of this incentive and its central role in maintaining the capacity of VCTs to continue raising funds for deployment in targeted SMEs.

Selected case studies of VCT investment

Liftango is working with public and corporate fleet operators, including academic institutions, to solve parking, congestion and commuting problems and to help create better public bus systems.

It is creating sustainable, demand-responsive transport solutions by implementing carpooling schemes and helping property developers design sites that take account of future mobility needs and minimise carbon footprints.

Its global network of climate-positive carpool partners includes Tesla and Unilever. Liftango received funding from Maven Capital Partners.

Founded by radiologists, Hexarad seeks to address the increasing backlog of medical images suffered by the NHS and private healthcare providers, allowing fast and accurate diagnosis for patients.

The company's clinically led and technology focused approach leads to better outcomes for customers and patients as well as an improved experience for radiologists across the UK

Hexarad received funding from Foresight Group.

Moonshot is a data analytics firm tackling threats online. It seeks to address online violent extremism, child sexual abuse and exploitation, disinformation networks, organised crime and other online harms. Its clients include governments, law enforcement, non-profit organisations and technology companies.

Moonshot provides clients with up-to-date trends, threat assessments, post-incident reporting as well as training and consultancy services to help action the threats arising from the digital environment. Its work helps make the internet safer for everyone. Moonshot received funding from Beringea.

Guru is helping the transition to a net-zero emissions future, using technology to improve the performance of heat networks, gas boilers and heat pumps.

Guru's technology captures data, provides analytics and enables remote control of heating systems to ensure that they work efficiently, reduce heat loss and are cost effective. Its collaboration with social housing organisations is leading to the replacement of old prepayment meters with more energy efficient systems and financial savings for residents.

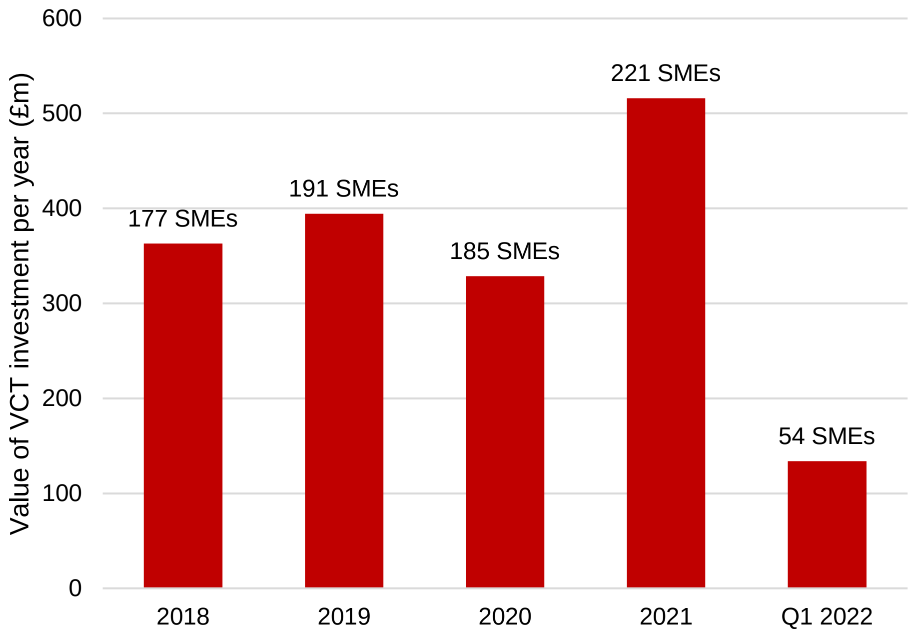
Maven Capital Partners provided funding to Guru.

Targeting investment on SMEs

Since 2018, VCTs have invested £1.7 billion into 532 different SMEs. This represents significant support for companies facing a finance gap.

As discussed in more detail below, many of these SMEs are technology-driven, many are KICs (Knowledge Intensive Companies). They are therefore a particularly important component of the SME sector and important recipients of development capital.

Fig 2: Value of VCT investment (and number of SMEs receiving funds by year)



Note: The number of SMEs does not total 532 as some received multiple investments

Integration between venture capital and start-ups

VCTs and their managers have relationships with a national network of advisers and business angels (including angel networks). This helps them identify investment opportunities. Many VCTs and their managers have ongoing relationships with serial entrepreneurs. Others have links with universities, which can be centres of innovation and investment opportunities. This ecosystem provides a strong pipeline of investment opportunities for VCTs.

There is a continual stream of start-up businesses being launched which, if they make sufficient commercial progress, could be suitable investments for VCTs in the future. The Office for National Statistics (ONS) recorded 358,000 business 'births' in 2020. The appetite to launch new ventures was potentially affected by the change in employment opportunities during the Covid-19 pandemic. Even so, business creation fell during 2020. In 2019, there were 390,000 start-ups. Of course, many of these new ventures are likely to remain small businesses. They will therefore provide important services and employment opportunities throughout the economy but not become engines of growth that demand external, risk capital. Those that do have the potential and ambition for growth may look to VCTs for their funding. The more start-ups there are, the more potential there is for future economic growth.

The ONS identified 12,000 high growth businesses in the UK in 2020. These were all businesses in the UK with an average growth in employment of greater than 20% per annum over a three-year period (between 2017 to 2020). The size threshold used to identify these businesses is that they have ten or more employees. Many of these businesses could be candidates for VCT investment. Unfortunately, the number of these high-growth businesses in the UK has reduced. In 2019 there were 13,000 such high-growth businesses.

Higher levels of business creation are important to create the pipeline for future investment. It requires a specialist skill set to identify SMEs suitable for investment by VCTs. The reservoir of experience within the VCTs is particularly valuable in maintaining and developing the link between start-up businesses and development capital.

Selected case studies of VCT investment

Solidatus

Launched in February 2017, Solidatus is a data management company offering a cloud-based data management platform. This gives organisations a view of their data processes, helping them to better understand how data flows through their organisation and how best to manage it.

Clients include global financial, pharmaceutical and retail firms. Solidatus has been named as the 'Best Data Lineage Solution' at the Data Management Review (DMR) Awards.

Albion Capital funded Solidatus.

SAIETTA

Saietta Group is an engineering company based in Oxfordshire. It has recently expanded its operation to Sunderland with 40 new staff.

Saietta developed a new design of electric axial flux technology (AFT) motor for vehicles. Its AFT motors can be integrated into lightweight zero-emissions vehicles, including scooters and motorcycles. This technology aims to play an integral role in cutting emissions and air pollution in densely populated, high traffic urban areas.

Saietta received funding from Amati Global Investors VCT.

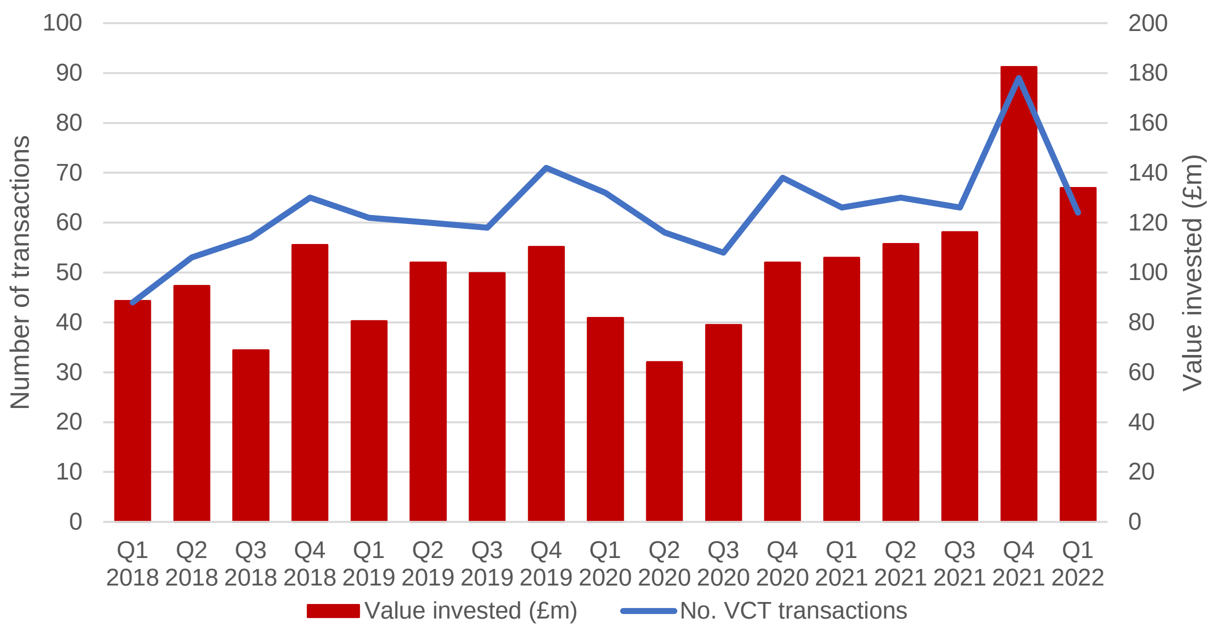
Supporting SMEs in challenging times

VCTs have been an important source of finance for SMEs through, and since, the Covid-19 shock. The sector is helping SMEs deal with current market turbulence arising from inflationary pressures and other uncertainty. Since the start of Covid-19 pandemic, 485 SMEs have received nearly £1 billion in funding from VCTs.

Banks are not a natural source of growth capital, because they lack the risk appetite or may require collateral which SME's seeking funding cannot provide. Loan financing on its own may also be less attractive to an SME than equity (or an equity/debt mix) which can be provided by a VCT. Nonetheless, it is notable that Bank of England data shows a consistent fall in the amount lent to SMEs since May 2021. The withdrawal of bank lending from SMEs suggests that the structural finance gap facing SMEs may be widening. A similar reduction in bank lending has not affected larger businesses. In fact, the opposite trend has been seen, with growing amounts being lent to those companies.

Fig 2 shows that VCT investment was resilient during the Covid-19 pandemic. Fig 3 gives a quarterly breakdown which sheds light on how investment activity was distributed through the period.

Fig 3: VCT investment activity by quarter



Selected case studies of VCT investment

Aptamer Group is a life sciences company that develops reagents and affinity binders for research, bioprocessing, diagnosis and therapeutic application.

Its products are used in the treatment of cancer and neurodegenerative diseases. Its proprietary Optimer platform engineers binders to address issues with alternative affinity molecules, such as antibodies, helping scientists make faster, more informed decisions that support discovery and development in life sciences. The technology also helped in the COVID-19 response. Aptamer received funding from Seneca Partners and Amati Global Investors.

Poolbeg Pharma is a London based pharmaceutical company which aims to develop biotech products quickly and cost effectively. It then partners with other companies to bring the products to market. It uses artificial intelligence (AI) to develop vaccines and treatments for infectious diseases.

Currently, it is using AI to research influenza, from infection to recovery. The company received funding from Seneca Partners.

Its shares trade on the AIM market of the London Stock Exchange and on the OTC Markets in the USA.

Pura manufactures eco-ethical baby products that are affordable for consumers looking to move away from traditional established brands. Their biodegradable nappies are made with 100% green electricity while their plastic-free and flushable wipes are made from sustainably sourced trees and comprised of 99% water and organic aloe vera. Pura's vision is to keep nappies out of landfill and make recycling the norm where recovered materials can be turned into everything from road surfaces, insulation and school notice boards.

Pura was funded by Maven Capital Partners.

Operating across London, LITTA offers an efficient, seven day-a-week, 24-hour, eco-friendly, end-to-end rubbish removal service covering all types of rubbish from domestic to commercial waste.

Its online booking service and smartphone app makes it easy for customers to arrange and track their rubbish collection. Litta recycles 96% of the waste it collects, including electrical and electronic equipment.

A £2million investment from Beringea allowed the company to invest in new technology and grow its staff to 15.

Fig 4: VCT investments by number and value (with first time investments split out)

Year	No. SMEs receiving investment	Value invested (£m)	No. SMEs receiving investment for the first time	Value invested (£m) in companies for the first time
Q1 2020	54	82	21	45
Q2 2020	49	64	15	28
Q3 2020	44	79	19	36
Q4 2020	61	104	27	63
Q1 2021	55	106	36	79
Q2 2021	54	111	34	76
Q3 2021	53	116	31	77
Q4 2021	74	182	43	113
Q1 2022	54	134	28	90
Total	NA	978	254	607

Note: The number of SMEs receiving investment does not total 485, as some SMEs received investments in more than one quarter.

When news of Covid-19 first emerged, VCT investment activity was maintained, albeit at slightly lower levels for the first three quarters of 2020. Since then, it has recovered.

For comparison, the ONS reported that business investment in the UK fell by just under 11% in the first quarter of 2021, leaving it some 17% lower than pre pandemic levels. VCT backed businesses in the same period received comparable levels of capital to the last quarter of 2019, showing the resilience of the investment structure and the desire of these SMEs to secure development capital. Record breaking levels of investment are possible in 2022 as the first quarter has been so strong and VCTs have significant amounts of capital to deploy to SMEs willing, and able to exploit opportunities arising from the post-Covid recovery.

As can be seen from Fig 4. VCTs have made substantial volumes of follow-on investments since the start of the Covid-19 pandemic. VCTs and their managers have demonstrated their commitment to backing SMEs through challenging times. Many of these SMEs are creating new products and services, often based on technology platforms, which are intended to take advantage of changing market dynamics. This would include, the creation of digital services, including artificial intelligence applications, and healthcare innovations in areas such as drug discovery. These kinds of businesses may be able to take advantage of the changing business dynamics created by the pandemic.

Given the fundraising challenges created by the pandemic it is particularly welcome that VCTs also invested in many SMEs for the first time after the pandemic hit. Some £600 million of the nearly £1 billion invested during the period was allocated to SMEs not previously supported by VCTs.

This pattern of investment demonstrates the risk appetite of VCTs, their ability to identify SMEs with credible business plans, and the capacity to maintain a pool of capital which can be deployed to support existing portfolio companies and to fund new opportunities.

Investing in technology

The government plans to reinforce the UK's position as a global science and technology superpower. Advice to the government from the Council for Science and Technology identified sustainably increasing investment in science and technology as critical to achieving this ambition.

VCT investment since 2018 has increasingly focussed on technology business. This reflects their increased appetite for risk, a growing investment in management capacity to assess and manage exposure to technology-based SMEs and a desire to capture the potential economic advantages which investing in these businesses can secure.

VCT managers have identified 190 SMEs receiving investment since 2018 as KICs. These businesses received £780 million of development capital, representing 45% of all funding during the period.

The number of SMEs with a technology-based commercial model is higher than indicated by these figures. The KIC criteria are complex and specific. Some businesses, for example, those based on digital technology, may have high-knowledge input but be driven by entrepreneurs without formal post-graduate qualifications (an important element in the KIC definition). Those most likely to meet the KIC requirements are potentially in pharmaceutical or life-sciences.

That said, some SMEs have benefited from the additional investment capacity allowed for KICs. A significant number of SMEs (37) have received over £5 million of VCT investment in a 12-month period since 2018. We have identified five SMEs receiving investment amounts which are greater than the £12 million lifetime limit. The actual numbers of SMEs benefiting from the KICs rules may be higher, as some SMEs may have also received finance from other State-aided sources, such as the EIS, during the period.

The higher levels of investment for technology-based businesses reflect the additional resources needed to develop novel products and systems before they can be commercially exploited.

VCTs are already an important source of funding for technology-orientated SMEs, and we expect this market focus to increase further in the future.

Levelling up

VCTs provide a national network of investors (with VCT managers operating out of 15 offices across the UK). This network, operated by competing commercial entities, would be directly replicable by, for example, government run regional investment hubs.

This infrastructure has supported investment across the UK (see Fig 5). London attracted the most investment. This is a natural consequence of the balance of UK economic activity. ONS data estimates that at the start of 2021 there were 5.6 million UK private sector businesses. Of them, just over one million were in London. Since 2010, the largest increase in businesses was seen in London (45% of those created). This makes London the largest pool of potential investments and VCTs have responded accordingly.

Selected case studies of VCT investment

amt

Additive Manufacturing Technologies (AMT) aims to enhance 3D printing and enable its use at industrial scale. Its technology platform, PostPro, automates the manual and costly steps of surface finishing or the 'postproduction' of 3D printed parts.

AMT's vapour-smoothing technology was developed at the University of Sheffield. The company's finished parts have been used by international customers in products ranging from prosthetics to automotive and aerospace. AMT operates in the UK, US and Europe and received funding from Foresight Group via Foresight Williams Technology.

HomeLink Healthcare

HomeLink Healthcare is helping to relieve the growing pressure on NHS hospitals by providing in-home nursing and therapeutic care to complement existing hospital-based patient services.

It offers pre-operative assessments, virtual wards, and early supported discharge services to reduce hospital bed-blocking. This improves healthcare efficiency by freeing up hospital capacity for those patients most in need. HomeLink's services are helping to ease the NHS elective care backlog.

HomeLink received funding from Foresight Group.

DeepStream

DeepStream is a cloud-based AI-powered online procurement platform. It helps buyers and suppliers to communicate, quote for business and negotiate efficiently. Its services replace emails, spreadsheets and legacy IT systems to create more effective processes.

DeepStream's technology automates processes to help reduce costs. The platform is entirely digital which eliminates the need to print, sign or scan documents and allows for the exchange of large amounts of information. It was founded in 2016 and has received funding from Beringea.

gelion
inspired energy

Gelion is a global renewable-energy storage innovator. Its leading-edge battery technology, created using low-cost raw materials, are scalable with applications in agriculture, mining, water management and irrigation. Its mobile energy division is enhancing existing battery technologies for use in electric vehicles and electric aviation. It is also working on a low-cost additive which increases the lifetime of its batteries by more than four times, delivering up to three times higher energy than conventional lithium batteries.

Gelion was funded by Seneca Partners.

Fig 5: VCT investment by region

	VCT investment since 2018			
Region	**No. SMEs**	**%**	**Value invested (£m)**	**%**
London	245	*49%*	907	*57%*
South East	68	*14%*	194	*12%*
North West	43	*9%*	117	*7%*
East of England	33	*7%*	88	*5%*
Scotland	23	*5%*	46	*3%*
North East	21	*4%*	56	*4%*
South West	19	*4%*	54	*3%*
Wales	15	*3%*	42	*3%*
East Midlands	14	*3%*	34	*2%*
West Midlands	14	*3%*	28	*2%*
Yorkshire and The Humber	5	*1%*	17	*1%*
Northern Ireland	3	*1%*	10	*1%*

VCT investment levels in the South East also followed the national pattern (this region ranks just after London in the ONS figures). In other regional/national patterns, it differs slightly. For example, Scotland ranks ninth in the ranking of UK business location.

VCT investment in Scotland is at a higher level, being ranked as the fifth most frequent area receiving investment.

Overall, VCT investment is relatively evenly spread across the UK once London and the South-East are excluded.

Annex: VCT rules and options for reform

Government support and the targeting of VCT investment

Governments of all political complexions have supported VCTs via tax incentives. These include a 30% income tax relief on a subscription for VCT shares. This relief is essential to mobilising capital for VCT investment. Retail investors also get relief from capital gains tax when they sell shares in the VCT and receive dividends tax free. The dividend relief is particularly useful in encouraging long-term holdings of VCTs.

In return for taxpayer support, VCTs invest at least 80% of their capital in a defined cohort of SMEs. The SMEs must have a permanent establishment in the UK and be in financial health (which reduces investment in 'lame ducks'). In general, the SME must be under seven years old and limited in size (their assets must be less than £16 million after they have received the investment).

There are limits on the activities that VCT-backed SMEs can undertake. Excluded activities include dealing in land, various financial services (including banking and money lending), leasing, providing legal or accountancy services, energy generation or steel, shipbuilding, and coal production. The financial services exclusions prevent VCT funds being used as a subsidised source of finance for other businesses. Some exclusions arise as a legacy from EU requirements (notably those relating to steel, shipbuilding, and coal). The money received by an SME from a VCT must be used to develop the relevant qualifying activity.

Generally speaking, SMEs are limited to receiving £12 million from VCTs (and other State aided investors). They can receive no more than £5 million in any 12-month period. The funds must be used to grow the SME. The investee business must be younger than seven years old when they receive their first State aided investment (from a VCT or other State aided investor). The SME must have fewer than 250 full time equivalent employees at the time of investment.

VCT investments are required to meet a principles-based 'risk to capital' condition. This ensures that, notwithstanding compliance with the specific requirements, funds are being devoted to SMEs which are the target of government policy. This rule, introduced in 2018, has seen the centre of gravity of VCT investment shift towards more risky investments. It has reinforced VCTs' focus on those SMEs most likely to face a finance gap because of the underlying commercial risks they are exposed to.

The VCT investment rules justify taxpayer support for VCTs and position the sector as a unique source of growth capital. The commercial strength of the sector indicates that, broadly speaking the balance of the regime has been correctly set.

Knowledge Intensive Companies (KICs)

The VCT rules recognise the benefit of supporting SMEs whose growth relies on a high level of intellectual input. This includes businesses involved in information technology, virtual reality, artificial intelligence as well as medical developments and biosciences. These SMEs tend to have higher capital requirements and may be loss-making for longer as their technology is developed and commercialised. Investing in them raises due diligence challenges as it is more difficult to assess propositions whose commercial potential relies on complex, novel scientific or other technological developments. The potential rewards of backing such SMEs, particularly those involved in digital innovation, have made them increasingly attractive to VCTs.

To facilitate greater investment in these types of SMEs, VCTs have a greater investment capacity where they are investing in Knowledge Intensive Companies (KICs). KICs can receive a total investment of £20 million (instead of £12 million). They can receive £10 million in any 12-month period (instead of £5 million). They can employ up to 500 full time equivalent employees (instead of 250). The KIC must have received its initial VCT (or other State aided investment) no longer than 10 years after its annual turnover reached £200,000.

To be a KIC, the SME must meet various tests. These include spending a certain proportion of its operating costs on research and development or innovation. The precise amount differs depending on the circumstances of the SME. The requirement may be met by spending undertaken before or after the VCT investment is made. As well as this ‘operating’ condition, the SME must meet either an ‘innovation’ condition or a ‘skilled-employees’ condition.

The innovation condition requires that, at the time of investment, it is reasonable to assume that within 10 years the SME’s business will rely on utilising intellectual property created by the company. The skilled employee condition, broadly speaking, requires at least 20% of the company’s employees to be engaged in research and development/innovation and to be educated to over Masters degree level.

The additional flexibility provided for investments in KICs was negotiated by the UK with the European Commission. The rules defining a KIC reflect the requirements of the Commission.

The full rules defining KICs are more complex than set out here. They are challenging to comply with. Nonetheless, the flexibility offered by the KIC rules is welcome. However, the compliance difficulties mean that VCTs often invest in SMEs which are likely to be considered KICs but choose not to invest on that basis. That is, they do not take advantage of the additional investment capacity available. This reduces the risk of making a non-qualifying investment.

Options to enhance the VCT tax rules

The VCT rules currently operate well. They support investment targeted on SMEs facing a finance gap which can make good use of development capital. They support strong fundraising by the sector to undertake this activity. Given this, the AIC’s primary objective is to ensure the maintenance of a vibrant VCT sector able to support SMEs. Essential to achieving this is removing the sunset clause which would prevent tax incentives being provided to retail investors on the subscription for new shares issued after 5 April 2025.

There is no urgent need to change other aspects of the rules. The AIC anticipates that HM Treasury has no pressing desire to change the rules. That said, in the medium term there could be value in reviewing and simplifying the rules. The intention would not be to change the risk profile of VCT investment. It would be to reduce compliance burdens and maximise the scope for investment within the cohort of SMEs targeted by the government’s policy.

Such reform might include:

- **Replacing the 15% investment test with a 'spread of risk' requirement:** VCTs cannot invest more than 15% of their assets in any one SME at the time of investment. This test seeks to ensure diversification. It was based on historic investment trust tax rules. The rules were modernised in 2012 and investment trusts no longer have a numerical limit. Instead, they have a spread of investment risk test. This approach reduces the complexity of compliance without changing the fundamental purpose of the regime and could be adopted for VCTs.

- **Distributing income from shares and securities:** Another hangover from historic investment trust tax rules is a requirement for VCTs not to retain an amount which is greater than 15% of the income it derived or will derive in the relevant period from shares or securities. VCTs are usually keen to distribute all their income so this requirement is simply not necessary and can be deleted. From the Exchequer's perspective, there would be no impact even if the company were to retain the income it receives, as investors do not pay tax on capital gains or dividends. Deleting this rule would provide VCTs with more flexibility and a lower compliance burden.

- **Introducing a 'minor breach' provision:** Any breach of the VCT rules could result in a loss of status, with significant implications for investors and the future of the VCT itself. The updated investment trust tax rules have a minor breach regime which could be adopted for VCTs. This would ensure a more proportionate regime where a breach arises while still requiring the VCT to impose proper systems and controls on its approach to compliance.

- **First commercial sale:** Generally speaking, VCTs may only make qualified investments in SMEs which have been established less than seven years or no longer than seven years after their 'first commercial sale' (whichever is later). The concept of a first commercial sale is unclear. Recognising this, the first commercial sale test for KICs starts the countdown on the age limit only once turnover has reached £200,000. A similar approach (possibly at a lesser amount) could be adopted for SMEs which are not KICs. This would simplify compliance and the assessment of qualifying investments.

- **KIC post-investment qualifying criteria:** As VCTs can invest more in KICs, it is legitimate to establish a clear boundary between these SMEs and others in the market. This reduces the potential for VCTs to have an inappropriate impact on competition. However, the KIC rules are very complicated. Some of the conditions must be complied with after the point of investment and/or require a judgement about the likely position of the company after the investment has been made. These create compliance challenges. There would be value in looking again at these rules to consider if they work as intended and if alternative rules could be implemented to deliver a similar outcome in a more straightforward way. A review might also identify other types of SME, defined by other characteristics, which government policy might wish to support.

- **Excluded activities:** Some excluded activities could be reviewed and revised. Some of these arise from EU requirements (notably involvement in shipbuilding and steel production). Many of the EU restrictions are unlikely to be relevant to the SME market but there could be opportunities for innovation in, say, shipbuilding that might be supported by VCTs. Delivering these changes would only be an option if VCTs were no longer subject to EU State aid approval. Otherwise, the Kalifa Review of UK Fintech proposed looking again at the exclusion of fintech where an SME, which previously received VCT investment, moves from unregulated to regulated activities. The aim would be to level the playing field for access to investment by fintech SMEs relative to other technology companies. There are pros and cons in excluding specified activities. However, there would be merit in reviewing the approach to confirm whether exclusions remain relevant to the government's policy goals.

There are other technical aspects of the rules which could be revised or removed. None of the issues identified above are fundamental to the success of VCTs but reform could help reduce compliance burdens and the risk of an inadvertent rule breach. Any changes that would refocus VCT investment so that it no longer meets the policy objectives for the scheme would be inappropriate. All these technical reforms are of secondary importance in comparison with removing the sunset clause.

Reforming the regulatory regime for VCTs

VCTs are listed companies operating within an established legal and regulatory framework. Aside from the tax rules which inform their investment strategies, they are governed by company law, the Listing Rules, accounting standards and fall within scope of the Alternative Investment Fund Managers Directive (AIFMD). The distribution of their shares to retail investors is also regulated.

Overall, these rules operate effectively. They provide investors with reliable information on the VCT and its activities and ensure high levels of governance. VCT managers, which supply key services to the VCT, are regulated, which supports an effective investment process which rightly attracts consumer confidence.

Notwithstanding this, the AIC is keen to see the Prospectus rules reformed. A prospectus is required when a company, including a VCT, first has its shares admitted to trading on the stock market. However, a prospectus can also be required when additional shares are issued by the company, even where identical shares are already available in the market. This situation arises where the level of share issuance is over 20% of the company's issued share capital. Also, where the shares are being issued via a public offer (which includes where they are being sold to a large number of retail investors).

The problem is that prospectuses are very compliance heavy documents. They are time consuming and costly to prepare. These costs are particularly onerous where the issuer, such as a VCT, is relatively small. The cost for these issuers is higher in relation to the amount of funds raised. A VCT might have to issue a prospectus each year where it is fundraising to maintain and build capital for investment in SMEs. This cost is a significant burden for the sector.

The regulatory value of these prospectuses is negligible, if they have any value at all. Existing shareholders determine if the company is allowed to issue new shares. This process is undertaken prior to the publication of the prospectus, so without the benefit of knowing what is in the prospectus. The FCA is expected to review these rules later this year.