VCTs: Investing for the future

VCT investment 1996 to 2012
May 2013
About the AIC

The Association of Investment Companies (AIC) represents closed-ended investment companies whose shares are traded on public markets. AIC members include 79 Venture Capital Trusts, which manage some 90% of the sector’s £2.6bn of assets.

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Important information

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1 Key findings

Venture Capital Trusts (VCTs) were launched in 1995 to encourage UK private investors to invest in small companies which need start-up, early stage or expansion capital. VCTs pool investors’ money and employ a professional fund manager to identify investment opportunities.

VCTs support businesses that promote innovation, industrial change and modernisation of working practices. These young companies often do not generate sufficient cashflow to service traditional forms of debt and so need other sources of finance. The amount of capital required often varies between £100,000 and £5 million, which is beyond the means of most individual investors but too small for traditional private equity firms.

1. AT AN AVERAGE SIZE OF £2.8m, VCT INVESTMENT IS FIRMLY TARGETED AT THE FINANCE GAP FACING UK SMEs

2. INVESTEES COMPANIES CREATED 52 NEW JOBS ON AVERAGE FOLLOWING INVESTMENT

3. INVESEEE COMPANIES CREATED £10.8m OF NEW TURNOVER ON AVERAGE FOLLOWING INVESTMENT

4. VCT INVESTMENT OFFERS MORE THAN MONEY. 78% OF INVESEEE COMPANIES HAD A REPRESENTATIVE OF THE VCT FUND MANAGEMENT TEAM JOIN THEIR BOARD

5. 41% OF INVESEEE COMPANIES DERIVED SOME INCOME FROM OVERSEAS SOURCES

6. TAX PAID IN 2012 ALONE IS EQUIVALENT TO 82% OF THE INITIAL INVESEEE TAX RELIEF

7. 31% OF COMPANIES INVESTED IN R&D IN THE LAST 12 MONTHS, WITH AN AVERAGE SPEND OF JUST OVER £1M PER COMPANY
VCTs: Investing for the future

VCT impact by region

1 Determined by main area of operations. £138.4m of investment was also reported into companies whose main area of operations was classified as “nationwide” or “international”. These companies reported a combined increase in turnover of £533.9m since investment, along with 1430 new jobs.
### VCT impact by sector

<table>
<thead>
<tr>
<th>Sector</th>
<th>Investment</th>
<th>New turnover</th>
<th>New jobs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BIOTECH/PHARMA</strong></td>
<td>£35.1m</td>
<td>£102.9m</td>
<td>480</td>
</tr>
<tr>
<td><strong>BUSINESS SERVICES</strong></td>
<td>£152.6m</td>
<td>£969.1m</td>
<td>2300</td>
</tr>
<tr>
<td><strong>CONSTRUCTION</strong></td>
<td>£45.6m</td>
<td>£45.1m</td>
<td>87</td>
</tr>
<tr>
<td><strong>ENERGY</strong></td>
<td>£6.8m</td>
<td>£0.5m</td>
<td>15</td>
</tr>
<tr>
<td><strong>ENERGY (RENEWABLES)</strong></td>
<td>£127.8m</td>
<td>£21.9m</td>
<td>79</td>
</tr>
<tr>
<td><strong>ENVIRONMENTAL SERVICES</strong></td>
<td>£21.4m</td>
<td>£135.6m</td>
<td>1313</td>
</tr>
<tr>
<td><strong>FINANCIAL SERVICES</strong></td>
<td>£5.8m</td>
<td>£20.1m</td>
<td>197</td>
</tr>
<tr>
<td><strong>HEALTHCARE</strong></td>
<td>£75.6m</td>
<td>£12.9m</td>
<td>2047</td>
</tr>
<tr>
<td><strong>LEISURE AND HOSPITALITY</strong></td>
<td>£175.4m</td>
<td>£438.6m</td>
<td>2343</td>
</tr>
<tr>
<td><strong>MANUFACTURING/ENGINEERING</strong></td>
<td>£77.3m</td>
<td>£156.5m</td>
<td>686</td>
</tr>
<tr>
<td><strong>MEDIA</strong></td>
<td>£63.6m</td>
<td>£95.9m</td>
<td>478</td>
</tr>
<tr>
<td><strong>RETAIL</strong></td>
<td>£37.1m</td>
<td>£233.3m</td>
<td>600</td>
</tr>
<tr>
<td><strong>TECHNOLOGY AND IT</strong></td>
<td>£193.7m</td>
<td>£409.7m</td>
<td>3126</td>
</tr>
<tr>
<td><strong>TELECOMMS</strong></td>
<td>£25.3m</td>
<td>£71.2m</td>
<td>207</td>
</tr>
<tr>
<td><strong>TRANSPORT</strong></td>
<td>£4.8m</td>
<td>£4m</td>
<td>-200</td>
</tr>
<tr>
<td><strong>OTHER</strong></td>
<td>£54.9m</td>
<td>£18.6m</td>
<td>374</td>
</tr>
</tbody>
</table>
2 Supporting SMEs in tough financial times

The Government’s 2010 green paper “Financing a private sector recovery” identified a finance gap facing SMEs of £250,000 to £5m. It is now estimated that the overall size of the finance gap could be between £84bn and £191bn over the next five years.²

The finance gap is the consequence of structural issues. Smaller investments are largely avoided by traditional private equity firms which consider this size too small in relation to their search and due diligence costs, but are outside the scope of traditional funding sources e.g. family, re-mortgaging, business angels.

VCTs are designed to invest in this area of the market. They are supported in this activity by tax reliefs provided to investors. Currently, for example, this includes a 30% income tax relief for retail shareholders on investment.

AIC members have provided details of existing investments worth £1.02bn in 399 SMEs. At an average size of £2.8m, VCT funding is firmly targeted at the finance gap.

Figure 1: Levels of VCT investment

² Boosting Finance Options for Business p.3
Initial and follow-on investment

Follow-on funding helps investee companies reinforce growth, exploit newly identified business opportunities, replace withdrawn bank funding or sustain the business through a difficult trading period. Being able to reinforce growth in successful companies can help counterbalance the impact of investments that do not yield a return.

The average length of a VCT investment in an SME is between 5 and 7 years, although many investments are held for longer. Follow-on investments are often made throughout the holding period to address ongoing financing issues. Of the 399 investee companies surveyed, 50% had received follow-on funding at some point since their initial investment. These companies, on average, received 2.8 rounds of follow-on funding, with an average size of just over £600,000 per tranche.

2012 investments

The problems of the long-term finance gap have been exacerbated by the financial crisis, in particular through restricted bank lending. The Breedon Report “Boosting Finance Options for Business” notes that since the financial crisis “the UK has one of the highest SME loan rejections rates in the European area, and that the decrease in the supply of loans to SMES in the UK has been much sharper than elsewhere”.

VCT investment has remained strong throughout the financial crisis. Respondents to this year’s survey provided details of 78 first time investments totalling £145m made in 2012. The average size of the first time investment in 2012 was £1.81m.

82 follow-on investments totalling £66m (£805,000 average) were also reported for 2012. This gives a total reported investment in 2012 of £211m in 160 companies, both new and existing. The figure for the sector as a whole, including investments not covered by this survey, can be expected to be higher.

3 Impact of VCT investment

Economic growth

VCT fund managers seek to maximise shareholder returns. They tend to work with, and provide advice to, the investee companies to increase their value of their investment.

VCT investment is therefore about more than just money. 78% of the companies receiving VCT investment that reported into this year’s survey have had a representative of the VCT fund management group join their board. Access to business experience of this nature can be

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3 Boosting Finance Options for Business p.13
invaluable to a small business. This is a benefit that is not delivered through other more traditional funding routes.

£800m of VCT investment into 254 companies has seen their combined turnover double to £5.4bn. This suggests that for every £1 of tax relief, at least £6 of new turnover is created.\(^4\)

As VCT investment is made into companies with a high risk profile (critically because of their size), not every investment will be a success. Accordingly, 32 of the 254 companies (12.6%) had a lower turnover in the last financial year than on investment.

So the figures demonstrate the value that VCT investment can bring, but also highlight the risks that investors face. It is these risks which justify the need for continued Government support in the form of upfront income tax relief and ongoing tax-free income and capital returns to secure investment in SMEs which face long-term finance constraints.

**Increased employment**

VCT investment can also drive significant employment growth.

The 271 investee companies surveyed showed combined employment increasing from 23,643 people at investment to 37,775 employees in the last financial year – a 60% increase. This represents an average of 52 new employees per investee company.

However, the potential for VCTs to support jobs does not result in a smooth process of employment creation. Modernising working practices and delivering innovation can lead to a temporary reduction in employees. 14% of investee companies have seen a fall in employee numbers post investment. Whilst any job loss is regrettable, this process can deliver a sustainable business model which is capable of supporting greater levels of future turnover and employment growth.

Of the reported companies, 15 have grown from having fewer than 250 employees to beyond this level. Current European State Aid rules governing the VCT scheme mean these companies are now ineligible for receiving further State Aided funding, regardless of any ongoing financing issues they may face or their current gross assets or turnover.

**4 Delivering exports**

The UKTI report “Bringing Home the Benefits” notes that “doing business overseas can not only lead directly to growth, but also to improvements in efficiency levels and to fostering ideas for new products and services.”\(^5\)

\(^4\) See appendix for details of how tax relief is calculated throughout this report.

\(^5\) Bringing Home the Benefits p.2
The Government wants to help double the UK’s exports to £1 trillion by 2020. VCT investments will play a role in helping to deliver this outcome.

41% of the companies receiving VCT investment derive some of their income from overseas sales. With a total of £1.1bn of turnover generated abroad, this is equivalent to an average of 42% of total turnover per exporter.

5 Encouraging R&D

31% of investee companies report an investment in R&D in the last 12 months, with an average spend of just over £1m per company.

With a total expenditure of £115m recorded, this compares favourably with the total up-front tax relief of £129m that was received on the VCT investments in these companies.

45 of the companies reporting R&D expenditure in the last financial year also provided data for R&D expenditure in last year’s AIC survey.6

For these 45 companies, the total R&D expenditure has increased by £16.5m, an average of £36,700 more per company.

Figure 2: Range of R&D expenditure (FY2012)

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6 Delivering growth: The role of VCTs – Impact of VCT investment 1998 - 2011
6 Securing a successful exit

Achieving a successful exit is a fundamental part of the cycle of VCT investment. VCT managers are experienced in supporting growing businesses and do not simply focus on short-term earnings, as a successful exit is dependent on investing in the business to improve its capabilities and ensure its long-term viability. VCTs are patient investors. The average VCT investment is held for around 6 years, though many companies remain in the portfolio of investments for ten years or more.

The VCT model is able to recycle some of the proceeds from divestment. A number of older VCTs have already invested their capital more than twice over as exit proceeds have been circulated back into new investments. This brings the benefits to the UK economy that are described in this report, without any further up-front tax relief being provided.

Successful exits also allow VCTs to return some of the profits to shareholders as dividends. This helps secure future funding as experience shows that satisfied VCT shareholders will often re-invest later in other VCT offers.

Figure 3 (below) provides a breakdown of the type of divestments made in 2012. The 46 exits recorded clearly demonstrate the success that VCTs have in identifying and growing small businesses in an area of the market which is fraught with risk. At least 76% of investee companies were sold as going concerns.

Figure 3: VCT divestments 2012

76% of investee companies exited from VCT portfolios as going concerns in 2012
7 Delivering value for money

At a time where pressure on Government finances is considerable, it is important that VCTs can justify the investor tax reliefs provided by the Exchequer.

For the 248 VCT investee companies for which details are available, the survey shows that in 2012 they paid at least £375m in tax. The total is likely to be higher, but the full data set is difficult to collect.

These companies have received a total of £799m VCT investment.

This investment would have been supported by £457m of upfront tax relief. The tax paid in just one year was equivalent to 82% of that sum. Naturally it can be assumed that a proportion of this tax would have been paid without VCT investment. However, the strength of growth demonstrated in this report suggests the returns would not have been as high without VCT investment.

With the average VCT investment being 5 to 7 years, the tax returns - combined with the evidence of increased economic activity and employment in investee companies - it is clear that the benefits brought by VCT investments will more than compensate for the relief provided to investors.

8 Conclusion

Small businesses in the UK face an ongoing finance gap.

VCT funding is being effectively targeted to address the long-term structural market failure. The combination of investment and business experience provides real and sustainable benefits to the wider UK economy.

The figures also demonstrate clearly the risks that retail shareholders face in allocating funding towards investment in SMEs.

Taken together these results justify the Government’s support for VCTs and the continued provision of tax reliefs to encourage investors and balance the risk/reward ratio.
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Appendix: Methodology

VCTs currently have active investments in nearly one thousand UK SMEs, and since their inception will have invested in – and successfully exited from – significantly more.

Collecting detailed data on these investments is difficult. This survey records the impact of £1.02bn of investments into 399 SMEs from 1996-2012. The AIC believes that this data provides a strong indication of the impact of VCT investment. The consistency of results with previous surveys supports this view.

The turnover and employment findings do not analyse companies receiving first-time investment in 2012 as this time frame is not sufficient to identify the impact of VCT investment. Data for 2012 investments has also been excluded for the sections on R&D, exports and taxation as this covers expenditure that cannot yet be linked to the VCT investment.

Details of the size of data pool used for each section is detailed below:

<table>
<thead>
<tr>
<th>Category</th>
<th>Number of investee companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>399</td>
</tr>
<tr>
<td>Turnover</td>
<td>254</td>
</tr>
<tr>
<td>Employment</td>
<td>271</td>
</tr>
<tr>
<td>Exports</td>
<td>322 (with 131 deriving some non-UK turnover in the last year)</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>322 (with 100 making R&amp;D expenditure in the last year)</td>
</tr>
<tr>
<td>Tax</td>
<td>248</td>
</tr>
</tbody>
</table>

Calculating tax relief

VCT shares are listed on the London Stock Exchange. An upfront income tax relief is available to retail investors subscribing to new VCT shares i.e. on launch of the VCT or when a VCT raises new money. This is a key incentive to invest in the scheme. VCT income tax relief benefits have changed over time as detailed below:

<table>
<thead>
<tr>
<th>Amount of income tax relief on subscription</th>
<th>6 April 1995 to 5 April 2000</th>
<th>6 April 2000 to 5 April 2004</th>
<th>6 April 2004 to 5 April 2006</th>
<th>6 April 2006 to date</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20%</td>
<td>20%</td>
<td>40%</td>
<td>30%</td>
</tr>
</tbody>
</table>

VCTs must adhere to a number of rules to secure this relief (and the other benefits of VCT status) set out in legislation. These include a requirement that 70% of their investments must be in ‘qualifying investments’ e.g. shares in SMEs which carry on certain qualifying trades.
Tax relief calculated throughout this report assumes that VCTs invest 70% of available funds in qualifying investments. Most mature VCTs usually hold 80% or more but this calculation assumes the minimum to ensure a conservative assumption of the cost versus benefit.

Similarly, the calculations in the report assume all investors receive an upfront income tax relief of 40%. Again this is designed to ensure a conservative estimate which maximises the possible cost to the taxpayer for the purposes of analysis as the 40% relief was only available to VCT funds raised for 2 of the 16 years of the VCT scheme and 40% money must have been invested for the first time between 2004 and 2009. Otherwise investments will have been made either from VCT funds benefiting from a lower rate of relief, or where the investment is being recycled (in effect without the benefit of any further upfront income tax relief).

**Example calculation**

<table>
<thead>
<tr>
<th>Total qualifying investment</th>
<th>70p</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total VCT funding</td>
<td>(70p ÷ 70%) £1</td>
</tr>
<tr>
<td>Total income tax relief</td>
<td>(£1 × 40%) 40p</td>
</tr>
</tbody>
</table>
Acknowledgements

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