Delivering growth: The role of VCTs

Impact of VCT investment 1998 - 2011

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Delivering growth: The role of VCTs

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1 Executive summary

Venture Capital Trusts (VCTs) deliver growth through providing investment, business experience and advice to small and medium sized enterprises (SMEs) which are then better able to increase turnover, employment and tax returns, secure access to overseas markets and invest in the research and development (R&D) supply chain. The AIC conducted a survey of its VCT members at the end of 2011, receiving data from 13 VCT managers with assets totalling £2bn, equivalent to approximately 75% of the sector. They provided details on investee companies which employ nearly 32,000 people with a combined turnover of £3.3bn.

- VCT investment is directed at SMEs. The vast majority of investments are targeted at the finance gap of £250,000 to £5m.
- Overall, companies who receive VCT investment demonstrate a significant increase in their economic activity following investment. For every £1 of upfront income tax relief received on VCT investment, £7 of new turnover is recorded.
- On average, companies receiving VCT investment deliver a 16% year on year increase in employee numbers.
- Securing changes to the state aid rules, including the increase in the headcount test for qualifying investments from 50 to 250, will reinforce VCTs' ability to finance SMEs struggling to secure development capital and support the Government’s growth agenda. However, the AIC recommends that the European authorities review the appropriateness of the use of headcounts as a test for a qualifying investment.
- VCT investee companies are characterised by an ambition for growth, evident in their focus on R&D and a desire to gain access to overseas markets. The survey indicates that R&D expenditure by investee companies in a single year is higher than the upfront income tax relief used to support VCT investment. This expenditure will drive additional benefits in the UK’s wider R&D supply chain.
- In their first full year of tax payment post investment, a company’s tax receipts are equivalent to 67% of the cost of income tax relief on the VCT investment. VCTs tend to hold their investments for 5-7 years, indicating that the tax returns from VCT investee companies will more than cover the income tax relief received.
- Some older VCTs have reinvested proceeds from disposals in new investments, in some cases investing their capital more than twice over, demonstrating consistent value for money on the original income tax relief.
- SME demand for VCT funding remains strong. The number of inquiries for VCT funding in 2011 was above the pre-2008 level. The conversion rate from inquiry to actual investment is showing signs of increasing from the 2009 level.

VCTs provide significant benefits to the UK economy in a cost effective manner. The AIC recommends that the Government reaffirms its commitment to the VCT sector through maintaining incentives to invest in VCTs and working with the EU to further review the state aid guidelines in 2013.
2 Introduction

The Association of Investment Companies (AIC) is the trade association for the closed-ended investment company sector. The AIC has 87 VCT members with approximately £2.4bn of assets under management. This represents around 90% of VCT assets.

The AIC’s 2010 report “Supporting enterprise and growth: the role of Venture Capital Trusts” provided a guide to the work of VCTs, where they invest in the UK and the type of companies in which they invest.

In January 2011 the AIC followed up this report with “Closing the finance gap: VCT funding for SMEs”. This included a series of policy recommendations to allow VCTs to better address the finance gap and support growth among the UK’s SMEs. Many of these were taken up by the Government which is currently seeking approval for these from the European Commission.

Due to the difficulty in obtaining bank financing, many UK SMEs remain unable to secure development capital from traditional sources. VCTs are able to help address this issue and stimulate enterprise, economic growth and employment. Adapting the scheme, and seeking EU approval for the proposed changes, remains an important means to deliver the Government’s priority of delivering economic growth in the UK.

The AIC collected data from 13 VCT managers, representing 75% of the sector’s assets under management. Information detailing turnover, employment, R&D, exports and tax returns was provided representing £735m of qualifying investments in 311 investee companies since 1998. This report provides more detail on the impact of VCT investment on the UK economy and why this is a cost effective intervention.

Information was not included for companies who received investment in 2011 as these companies would not necessarily have had sufficient time for the impact of VCT investment to be seen. Instances of incomplete data mean that not all 311 companies could be included in each separate analysis. Details of the size of data pool used for each section is detailed below:

<table>
<thead>
<tr>
<th>Category</th>
<th>Number of companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment</td>
<td>311</td>
</tr>
<tr>
<td>Turnover</td>
<td>189</td>
</tr>
<tr>
<td>Employment</td>
<td>220</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>311 (with 97 making R&amp;D expenditure in the last year)</td>
</tr>
<tr>
<td>Exports</td>
<td>311 (with 127 deriving some turnover from exports in the last year)</td>
</tr>
<tr>
<td>Tax</td>
<td>239</td>
</tr>
</tbody>
</table>

1 www.theaic.co.uk/Documents/Technical/AICVCTreportMarch2010.pdf
2 www.theaic.co.uk/Documents/Technical/AICResearchClosingtheFinanceGapJan2011%5b1%5d.pdf
3 For example, to show the impact of investment on turnover, data would need to be provided showing year of investment, size of investment, turnover on investment and turnover in last financial year. If one of these was missing, the company would be excluded from analysis.
An ‘average’ VCT investment

VCTs typically invest in a diverse range of innovative companies with high growth potential, the ability to create employment, the ambition to secure revenue from abroad as well as the UK and the appetite to invest heavily in research and development.

Company at investment: On investment, an average company is on the fringes of the “medium” sized enterprise category as defined by the European Commission (50-250 employees, turnover between £8.35m and £41m)
- Turnover: £7.9m
- Employees: 68

Financing: The average investment size fits firmly in the finance gap of £250,000 to £5m identified in the Government’s “Financing a private sector recovery” green paper.
- Total investment: £2.3m

Experience: VCT investment offers invaluable skills as well as capital to boost growth prospects. 87% of companies have a VCT representative join the board.

Life of investment: A VCT tends to maintain its investment in a company for between 5 and 7 years (although this is dependent on the overall economic environment).
- Time since investment: 6 years

Company after 6 years investment: The CBI has reported that firms with a turnover of between £10m and £100m represent less than 1% of businesses in the UK, but generate 22% of economic revenue and 16% of jobs. Investment has helped move the typical VCT investee company into this critical layer of the UK’s economy.
- Turnover: £18.3m
- Employees: 166

All data used is based on the average figure of the companies used in each section of this report.
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Geographical and sector spread of VCT investment

VCTs invest in many hundreds of small UK businesses in sectors as diverse as leisure and hospitality, media, telecoms, healthcare (including biotech), construction and renewable energy. They have the potential to stimulate growth in commercial sectors which have been identified by policy makers as important sources of future economic activity for the UK.

VCTs are also able to invest across the country. With fund managers located in Aberdeen, Birmingham, Bristol, Edinburgh, Glasgow, Leeds, Liverpool, London, Manchester, Newcastle and Oxford they are uniquely able to support companies facing a funding gap wherever they are located.

Assisting AIM traded companies

37% of VCT investments were in companies whose shares are traded on the Alternative Investment Market (AIM). VCT investment and expertise provides investee companies with the platform for growth during this hugely important stage of corporate development for SMEs.
3 Targeting the finance gap

The total of qualifying investments received by the 311 investee companies was £735m. Figure 1 shows the breakdown of the total amount (initial investment plus follow-on funding) invested by an individual VCT into a single company.

**Figure 1: Level of VCT investment received by UK SMEs**

Of the total number of investments, 85% (67% by value) were in the ‘finance gap’ of £250,000 to £5m, identified in the Government’s “Financing a private sector recovery” green paper. VCTs are targeting the SMEs identified as most in need.

Even allowing for higher investment limits and the removal of the £1m limit on investment by each VCT, the sector’s track record indicates it will continue to invest across the entire universe of eligible SMEs, including those at the bottom of the allowable range.

When an investment was made which totalled £5m or more we anticipate that this will primarily have represented VCTs providing follow-on funding and reinvesting in a successful opportunity. This flexibility is essential to balance the risk/reward ratio of the reinvestment.

4 Increasing economic activity

Securing VCT funding can be a demanding process involving stringent due diligence prior to the provision of funding and a willingness by entrepreneurs to dilute their own equity share.
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Companies choose this route if they are committed to growth and recognise that this can be better achieved through the capital and experience a VCT investment manager can bring. Additional skills are an important part of the VCT ‘package’ and one of the reasons why investee companies experience such strong growth. Previous AIC research highlighted that 87% of investee companies had a representative of the VCT’s investment management team join their board of directors.

VCTs commit these additional resources to support their own obligations to deliver enhanced returns to their investors. This incentivises them to identify and invest in SMEs with real growth potential. It is therefore unsurprising that companies who receive VCT investment will, overall, see higher than average growth rates.

The AIC received turnover information from 189 investee companies who had a total turnover at the time of investment of £1.5bn. For these companies:

- Turnover in the last financial year had increased to £3.3bn, a 120% increase.
- 85% of the investee companies had a higher turnover in the last financial year than on investment.
- Three companies now have a turnover figure more than £100m higher than on investment.
- £1 of income tax relief on VCT investments supports the creation of £7 of new turnover for an investee company. ⁴

However, just receiving VCT investment does not guarantee growth for the company and an increase in the turnover of an investee company does not necessarily equate to returns to VCT shareholders.

- Of the 189 investee companies, 23 (12%) have seen a decline in turnover.
- The top 10% of companies by turnover saw an average compound annual growth rate in turnover of 58%.
- The bottom performing 10% saw turnover fall by an average of 10% year-on-year post investment.

This illustrates the risks taken by the VCTs, their shareholders and the investee companies - not all investments provide success. However, it is the balance between risk and reward that makes investment in VCTs an attractive proposition for investors and a valuable source of finance for SMEs. This explains the need for continued state support in the form of upfront income tax relief in a difficult part of the market.

⁴ See appendix for details on how tax relief has been calculated throughout the paper.
138 of the 189 investments were made into companies with a turnover of less than £10m. Following VCT investment, 42 of these businesses had moved into the £10m to £100m category, identified by the CBI as the sector in the UK that generates 22% of economic revenue and 16% of jobs. Of the 51 companies in the £10m to £100m turnover bracket on investment, 82% had a higher turnover in the last financial year than on investment.

Figure 2 shows the average compound annual growth rates (CAGR) of companies’ turnover, broken down by the year in which they first received VCT investment. The chart also shows the year-on-year change in the figures for the UK’s GDP, adjusted for inflation. For the average company, since 2000, turnover grew at a compound annual growth rate of 15%. For the UK GDP over the same period the figure is approximately 1.7%.

The spike for companies receiving investment in 2009 appears anomalous; however, we believe there are various factors behind it. There was a smaller pool of investee companies as a consequence of the lower number of transactions completed in the immediate aftermath of the financial crisis where there was a lower demand for funding because of market uncertainty.

Deals which VCT managers would have expected to transact in 2009 were not in the pipeline because of the disruption to the SME market in 2008 (see Figure 6 for more detail). Many SMEs postponed development projects which affected dealflow. In some instances VCTs were less able to complete deals because of uncertainties in valuations and risk assessment with differences in views between
VCTs and investee companies. Those that were completed tended to represent the strongest propositions, hence the significantly greater impact of VCT investment.

The spike may also reflect the tendency for companies securing VCT funding to see rapid growth particularly within the first couple of years of investment, which then will fall over time to a longer term average within the 10-15% range. However, it is quite clear that companies who received VCT investments in 2009 and throughout the period have delivered growth rates far stronger than the wider UK economy.

5 Employment growth

VCT investment supports employment growth. Data on employment changes was provided by 220 investee companies who employed a total of 15,066 people on investment. For these companies:

- In the last financial year the total employment figure was 31,820, an increase of 16,754 employees.
- This represents an overall rise of 111% and an average annual year-on-year growth rate of 16%.

Figure 3 looks at the range of annual growth rates and shows that the majority of companies saw an annual year-on-year growth rate of between 0 and 20%. 37 companies (17%) saw a fall in the number of employees.

Figure 3: Range of annual growth rates of employee numbers
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Any decline in employee numbers reflects the risks faced by SMEs or the business reorganisation that is often part and parcel of VCT investment. Such reorganisation seeks to deliver a more sustainable business model which is better able to support the remaining employee numbers and places the company in a stronger position to achieve future growth.

Impact of employee headcount limits

Changes to the VCT scheme introduced in April 2007 meant that funds raised after this date could not be invested in companies with more than 50 employees. The AIC has concerns that the ‘headcount test’ has no bearing on the ability of companies to access development capital, nor does it recognise that SMEs operating in different sectors (for example a technology company compared to a construction company) need different numbers of employees to achieve similar turnover.

This restriction arises from EU rules. Preventing investment in SMEs that are able to sustain a high employee level seems counterintuitive given that employment creation is a Europe-wide priority. Had the headcount limit of 50 been applied to funds raised before April 2007, 96 companies would have become ineligible for VCT investment. These companies have seen an increase of 12,106 jobs – 72% of the total increase in employment for all 220 companies.

The number of companies with over 250 employees has risen from 6 to 30 following VCT investment. On passing 250, these companies would become ineligible for follow-on investment by any VCTs with a headcount test (even at the higher level of 250).

A denial of VCT follow-on investment could hinder the further growth of the investee company which may still face a finance gap and sit within the gross assets limit set by the state aid rules. Nevertheless, the current approach to state aid means that it would not be able to receive funding from risk capital schemes.

Losing access to such funding is potentially damaging for growing SMEs. It could result in a reverse in the gains made following the initial investment or could encourage companies to limit their employment growth to ensure they remain within the limits for VCT funding. The AIC therefore recommends that the EU reconsiders the appropriateness of continuing to use a headcount test, or adjusting the rules to allow follow-on investment without imposing a subsequent headcount limit.

6 Focus on R&D

VCT investee companies have ambitions for development supported by a focus upon R&D which is not common for other UK SMEs5.

97 investee companies disclosed R&D expenditure of £112m in the last financial year. Just this one year’s expenditures is equivalent to 118% of the overall income tax relief received since 1998. Figure

5 AIC briefing paper, March 2010 “Supporting enterprise and growth: the role of venture capital trusts”.
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4 shows the range of investment for companies who identified expenditure on R&D in the last year, with 25% spending over £1m.

Figure 4: Amount of R&D expenditure in last financial year

7 Desire for overseas expansion

Access to overseas markets is a significant challenge to many SMEs. Achieving success abroad is a useful indicator of the commercial potential of a company. It has been estimated that 60% of UK productivity growth between 1996 and 2004 was attributable to exporting firms.6

- 41% of companies in our sample derived some of their turnover from export activities. This compares very favourably to the figure for UK SMEs as a whole, of whom approximately only 20% export.7
- 36% (£734m) of their total turnover came from exports last year.
- An overall total of £144m of Government support (in the form of upfront income tax relief) was used to generate these earnings.

6 Richard Harris and Q Cher Li, Firm Level Empirical Study of the Contribution of Exporting to UK Productivity Growth, March 2007
7 ICAEW: UK Enterprise Survey – Export Report
As shown in Figure 5, given the challenges in accessing overseas markets, of those companies that derive non-UK turnover, the greatest number earn less than 25% of their turnover from abroad. However, an impressive 28% earn over three-quarters of their turnover overseas, demonstrating the strength and high levels of ambition of VCT investee companies.

Figure 5: Proportion of turnover earned outside the UK

8 Value for money

One of the major incentives encouraging VCT investment is the income tax relief available to retail shareholders. The average shareholder investment in a VCT is between £12,000-£15,000. These investors are representative of the ‘mass affluent’ and not the very small percentage of very rich people in the UK. Their investment has helped provide SMEs in the UK with the funding necessary to survive and grow.

Analysis of the 239 companies for which data was available shows that their tax returns (payroll, national insurance, business rates and corporation tax) in the last full financial year totalled £387m. We estimate that the VCT investment in these companies would have received £321m of income tax relief.

- Just one year of tax payments by these VCT backed companies was £66m greater than the upfront income tax relief received by VCT investors.

It is true that, even without VCT investment, some of this tax revenue would have been received. However, the strong turnover growth promoted by VCT investment (see section 4) suggests that the tax returns from these companies would not have been as high without VCT investment.
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- For the 28 companies identified who received their first investment in 2010, in their first full year post-investment, their tax returns of £24m were equivalent to 67% of the value of tax relief received (estimated at £36m).

- VCT investments tend to be held for 5 years, indicating that the tax returns from VCT investee companies will more than cover the income tax relief received on investments. Even assuming no further growth by these companies, 5 years of tax payments would be 3.5 times the value of up front income tax relief received.

- The VCT fund model is predicated on recycling the proceeds from divestment. This means that VCT money may be recycled when an interest in a business is sold. Some older VCTs have already invested their capital more than twice over as exit proceeds have been circulated back into new investments. This drives further tax returns from investee companies without any further up front income tax relief.

9 Demand for VCT funding

5 VCT managers, representing 37% of the sector in terms of assets under management, provided data on demand for VCT funding. This data, as shown in Figure 6, shows conversion rates of 1% -2.5%. This is comparable with the wider private equity market. It suggests that VCTs are employing commercial discipline and due diligence meaning that tax payer funding is channelled wisely. This maximises the value for money of the scheme and minimises the funding of “lame ducks”. It also maximises the potential for VCTs to deliver shareholder returns and to generate further funds for reinvestment. This reinvestment spreads the benefits of the income tax relief and enhances the cost efficiency of the scheme.

Dealflow stalled in 2009/10 as VCTs and entrepreneurs sought to reconcile their expectations in changed market conditions. It took some time for both sides to reach a common view on companies’ prospects and value. As the market has settled, those positions have been reconciled and investors and SMEs are increasingly able to reach a mutually acceptable view. As a result dealflow is increasing.

The AIC understands that the current pipeline of deals is stronger than for some time and investment conditions are now more positive than they have been for the last few years. Demand for VCT funding from SMEs is strong. Arguably, demand is greater than before the financial crisis. Expectations are that this trend will be maintained.
10 Future of the VCT scheme

The VCT sector has a positive impact on the UK economy through supporting increased tax returns, turnover and employment and investment in the R&D supply chain.

The AIC welcomes the Government’s efforts to broaden the scope of allowable VCT investments, which could expand funding opportunities for SMEs seeking development capital in challenging market conditions. Convincing the European Commission to allow VCTs to invest in a wider range of business is a demanding task. Ministers’ determination to see these negotiations through to a successful conclusion is invaluable.

The AIC recommends that the Government reaffirms its support and commitment to the VCT scheme through maintaining incentives to invest in VCTs. The UK and EU authorities should further review the state aid guidelines to establish if provisions such as the headcount test remain valid in the current economic environment SMEs face.
Appendix: 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>Period</th>
<th>Amount of income tax relief on subscription</th>
</tr>
</thead>
<tbody>
<tr>
<td>6 April 1995 to 5 April 2000</td>
<td>20%</td>
</tr>
<tr>
<td>6 April 2000 to 5 April 2004</td>
<td>20%</td>
</tr>
<tr>
<td>6 April 2004 to 5 April 2006</td>
<td>40%</td>
</tr>
<tr>
<td>6 April 2006 to date</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

| Total qualifying investment | 70p  |
| Total VCT funding          | (£1  |
| Total income tax relief    | (40p) |

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