Venture Capital Trust Association

Response to the TheCityUK Recapitalisation Group Interim Report

1. About the VCTA, and how VCTs support businesses

Venture Capital Trusts (VCTs) invest in high-growth small businesses that meet defined rules, applied through a combination of State Aid criteria and UK legislation. The long-standing VCT scheme offers a tax relief to private individuals investing into VCTs, which then invest patient growth capital into a range of businesses that would struggle to attract conventional funding. In addition to funding, VCTs provide intensive business support and advice to develop their growth potential through fund managers' experience.

In aggregate, VCT funds under management total £4.5bn. This is deployed and managed by independent fund managers through an extensive regional network of local offices in more than 15 cities around the UK. In 2019, VCTs invested over £470m, investing in more than 100 companies for the first time and providing follow-on capital to existing portfolio companies to support their scale-up plans.

The Venture Capital Trust Association (VCTA) represents ten of the largest VCTs, making up over 75% of the VCT industry. Our members support over 1,000 small businesses across the UK, with more than 70,000 employees and £13.5bn of sales, of which a quarter are exports. The businesses we support range across sectors as diverse as digital technology, medicine development, specialist manufacturing and online retailing. The ten fund managers we represent are: Octopus, Gresham House, Albion Capital, Foresight Group, Downing, Beringea, Mercia, Mobeus Equity Partners, Maven Capital Partners and YFM Private Equity.

2. Identifying the funding gap

The interim report from the Recapitalisation Group (the "Interim Report") identifies two key challenges – managing the recapitalisation of the debt burden taken on by businesses as a result of the coronavirus pandemic, and ensuring that growth and scale-up businesses have access to sufficient growth capital. Our response focuses on the second of these two challenges.

While the VCT scheme has been very successful in providing growth capital to early-stage SMEs, particularly in technology sectors, we believe that there is a funding gap, or market failure, for growth businesses which do not qualify for VCT funding under the existing rules and those companies which can attract investment from fully commercial VC funds.

As the Interim Report identifies, while equity investment into UK SMEs has been growing, large differences in investment levels remain across the UK. The existing VCT, EIS and SEIS rules are designed to focus investment into early stage technology companies, which tend to be more concentrated in London and the South-East. While these businesses are vital to the future of the UK economy, solutions must also be found which provide more investment to other industries, spread more widely around the UK. In particular, this will require a reconsideration of the age limits which currently apply to VCT investment, which these regionally distributed companies are less likely to meet.

The other key group of companies whose growth prospects are adversely affected by the funding gap between VCT funding and fully commercial investors are “scale-up” companies which have reached the lifetime limit on the permissible amount of “State Aided” funding. The hard limits on investment size create inefficiencies as businesses transition away from tax-incentivised investment, particularly due to the inability of Angels and VCTs to provide follow on funding[1]. Solutions must ensure that this group of companies is able to continue to access the “patient capital” they need to reach their full potential, rather than remain “stuck” in a mode of incremental growth, or accept a trade sale as the most convenient exit, both of which are ultimately to the detriment of the UK economy, tax receipts and job creation[2].

3. Sources of funding

The success of the VCT, EIS and SEIS schemes demonstrate that retail investors are willing to commit substantial amounts for long-term investment into SMEs, where appropriate incentives are provided through government intervention. They are an excellent example of a successful public-private partnership.

The VCT scheme in particular provides a framework for how investments into small, illiquid private companies can be structured in a way which makes them suitable for private investors. VCTs pool investors’ commitments into companies listed on the Stock Exchange, similar to investment trusts, closed-end funds that many investors are already familiar with. VCTs then invest in a diversified portfolio of SMEs, thereby reducing risk for investors, while at the same time creating significant efficiencies for the managers in both raising funds and deploying capital. Investors can achieve liquidity for their investment by selling their shares in the VCT. However, a sale within five years of subscription will result in the initial tax relief being lost, thereby locking in funds and ensuring a pool of truly patient capital. Transparency and accountability are ensured by the Stock Exchange listing and oversight by an independent board of directors.

We believe that extending the existing VCT scheme, as discussed below, has the potential to attract substantial additional investment from retail investors, while maintaining appropriate investor protections.

We also believe that pension funds and other institutional investors, who already invest in VC funds targeted at later stage companies, may be attracted to invest into an expanded VCT scheme, if there are appropriate incentives similar to those provided to retail investors.

4. Potential enablement vehicles

The Interim Report identifies that there are at least two market failure concerns to consider, first that the volume of capital directed at the mid-market will be insufficient to meet the recapitalisation need, and secondly, that the operational capacity to distribute the capital is currently sub scale.

We address each of these market failures below:

---

[1] Patient Capital Review, Industry Panel Response, October 2017, page 6
[2] Patient Capital Review, Industry Panel Response, October 2017, page 7

4.1 Insufficiency of capital directed at the mid-market

We have identified that as part of this market failure there is a funding gap for growth businesses which do not qualify for VCT funding under the rules set out in the existing legislation, and those companies which can attract investment from fully commercial VC funds. This is a restriction both on the ability of growth companies to continue to scale, where they have reached the lifetime limit on the funds they can raise from tax-advantaged schemes, and on the growth ambitions of companies in the UK regions where they do not meet the age requirements under the current rules.

We believe that this funding gap can be addressed by changing the rules defining which companies are eligible for VCT funding, to widen the range of companies which can benefit from the scheme, increase the amount of capital deployed and distribute it more equally around the UK.

This opportunity was first identified by the Industry Panel Response to the Patient Capital Review in 2017. This stated:

Extending the investment limits for existing EIS and VCT schemes: *The popularity of these schemes has contributed significantly to the development of a vibrant UK start-up scene. However, the hard limits on investment size create inefficiencies as businesses transition away from tax incentivised investment, particularly due to the inability of Angels and VCTs to provide follow-on funding. To minimise this impact, the limits could be extended or removed, smoothing the transition from EIS / VCT funding to venture and raising up to an additional £1bn[3].*

It went on to suggest that one way of achieving this, while minimising the cost to government, would be to create a new "Growth VCT" with a reduced level of tax relief. This would have the ability to invest in a wider range of businesses than existing VCTs, while still being focused on smaller growth businesses which are not yet attractive to fully commercial investors.

An alternative approach would be to change the existing restrictions which apply to VCT investment to achieve the same objective of addressing the funding gap between VCT and venture funding. The VCTA is currently exploring both approaches, with a view to making a more detailed proposal on the optimum solution.

Whichever approach is ultimately adopted, it would provide another rung on the "funding ladder" for scaling UK businesses.

4.2 Sub-scale deployment infrastructure

The Interim Report concludes that in order to meet the deployment challenge: "*a combination of both the scaling up of existing infrastructure across multiple providers and the development of new operational capabilities will be required. The re-use, integration and build-out of existing and new components offers significant potential to enable rapid deployment and at scale to meet the sustainable industrial strength capabilities necessary."*

The VCT industry already has a substantial regional infrastructure, comprising c. 200 investment professionals with experience of investing in and supporting SMEs, spread across offices in more than 15 regional cities. These offices already manage total funds of c. £4.5bn. This infrastructure could rapidly be scaled to manage significantly larger amounts of capital and ensure its effective and rapid deployment, financed by the additional management fees earned on the larger pools of capital. Building on the existing VCT infrastructure in this way would also stimulate the development of local financial and professional support ecosystems in regional hubs, which could in turn result in a higher level of entrepreneurial activity.

[3] Patient Capital Review, Industry Panel Response, October 2017, page 7

5. Regulatory considerations

The existing VCT scheme has already been approved by the European Commission as Notified State Aid. However, any changes to the existing scheme, or the introduction of a new "Growth VCT", to target a wider range of businesses, would require clearance by the European Commission, or, if the UK should reach the end of the transition period without a deal, the Competition and Markets Authority as the designated UK state aid regulator.

We agree with the conclusion of the interim report of the RCG that solutions to the recapitalisation challenge are likely to require partnership between the private and public sectors which go beyond current interventions. While a "Growth VCT" with a wider investment remit would require regulatory approval, we believe that such approval would be justified by the market failure identified by the Interim Report and highlighted in this submission.

Whilst it would understandably take time to obtain this approval, it should be possible to achieve this more quickly than setting up an entirely new operating model.

6. Conclusion

Establishing a 'Growth VCT' structure, or changing the rules which apply to the existing VCT scheme, has significant potential to unlock significant additional funding for UK SMEs. This would leverage an investment product that retail investors are familiar with and which has appropriate investor protections. It could also potentially attract investment from institutional investors. The additional funds raised could be deployed rapidly right across the UK, through an established regional infrastructure.