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BVCA Response to consultation paper: "Tax-advantaged venture capital schemes: a consultation"

BVCA RESPONSE TO HM TREASURYS "CONSULTATION PAPER:" TAX ADVANTAGED VENTURE CAPITAL SCHEMES: A CONSULTATION

About the BVCA: The British Private Equity & Venture Capital Association (BVCA) is the industry body and public policy advocate for the private equity and venture capital industry in the UK.

The BVCA Membership comprises over 230 private equity, midmarket and venture capital firms with an accumulated total of approximately £32 billion funds under management; as well as over 220 professional advisory firms, including legal, accounting, regulatory and tax advisers, corporate financiers, due diligence professionals, environmental advisers, transaction services providers, and placement agents. Additional members include international investors and funds-of-funds, secondary purchasers, university teams and academics and fellow national private equity and venture capital associations globally.

As a result of the BVCA's activity and reputation-building efforts, private equity and venture capital today have a public face. Venture capital is behind some of the most cutting-edge innovations coming out of the UK that many of us take for granted: the medical diagnostic services we use in hospitals, the chips in our mobile phones, the manufactured components of our cars, and the bioethanol fuels that may run them in the future. Likewise, private equity is behind a range of recognisable High Street brands, such as Boots, Phones4U, Birds Eye, National Grid and Travelodge.

1. Introduction

This consultation on venture capital schemes is a timely one. The investment climate remains a difficult one for seed, start-up and early and late stage venture capital. The table below shows that in terms of total amount invested and number of investments made, all these categories have been in recent decline.

Venture capital investors continue to finance a significant number of early stage companies, both in the UK and abroad (479 in total for 2010, compared with 429 for 2009), accounting for 45% of all companies that received funding by BVCA members in 2010. Yet amounts of venture capital investment remained relatively subdued, with investments in UK companies falling to £313mn last year from £454mn in 2009, and overseas investments down from £219mn in 2009 to £198mn in 2010. [1]

[1] BVCA RIA 2010

Table 4. **UK Investment by Financing Stage**

Financing Stage	Number of companies			% of companies			Amount invested (£m)			% of amount invested		
	2010	2009	2008	2010	2009	2008	2010	2009	2008	2010	2009	2008
Seed	39	37	67	4	4	5	10	14	12	-	-	-
Start-up	65	57	103	7	7	8	46	125	160	1	3	2
Early Stage	219	191	285	24	22	21	168	164	187	2	3	2
Later stage VC	74	80	n/a	8	9	n/a	89	151	n/a	1	3	n/a
Total Venture Capital	397	365	455	44	43	34	313	454	359	4	9	4

1. The number of companies in some financing stage categories and their subtotals add up to more than the total number of companies invested in. This is due to some companies receiving more than one investment within the year at different financing stages. Please refer to the appendix in the full report for further information.

2. – indicates a value greater than 0 but less than 0.5

Source: BVCA Report on Investment Activity 2010

With these sector wide indicators in mind, an appraisal of the whole funding ladder is necessary, with particular emphasis placed on ensuring access to capital throughout. EIS and VCTs, conventional LPs and angels must all be encouraged to work together, to pool their capital so they can invest right across the life cycle of a company.

The BVCA has long called for extensions to EIS and VCTs as they will lead to considerably more investment in UK SMEs. It is important though, that these proposals are integrated well with the rest of the funding ladder, be it with new proposals for seed (BASIS) or their impact on conventional LP funding of later-stage venture capital.

Taking the whole of the funding landscape, it is worth noting that contrary to received wisdom, in the UK we invest in as many start-ups (200-250) each year as Silicon Valley, through small investments of £0.5-4m. But just taking 2010, 45x as much VC investment took place in the US compared with the UK – we are not behind the US in terms of the number of companies which receive VC funding. Other than GDP/population, almost all of the difference is due to the fact that US VC investments were on average 5.5x higher per company in the US than in the UK[2].

The UK has no shortage of entrepreneurs and they are well supported by government schemes. The problem comes when joining up seed funding with later stage venture and it is here that attention is required. We should look to build a framework that generates increased investment but also continues to invest throughout the life of that company.

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[2] BVCA/NVCA statistics also see http://admin.bvca.co.uk//library/documents/Benchmarking_UK_VC_to_Israel_and_the_US.pdf

The BVCA therefore welcomes the Treasury's consultation paper. In building on the measures to enhance venture capital schemes in the last Budget, the consultation recognises the importance of VCTs and EIS to the UK economy, and also introduces some important measures to enhance their focus. The BVCA recognises that the Treasury is the single largest stakeholder in VCTs and EIS, through its provision of tax relief to investors, and therefore it is essential that the Treasury gets appropriate return on its commitment. The "focus" measures will help to provide this, though we would also suggest that the venture capital industry should gather additional data over time in areas such as employment growth, to provide more metrics for the Treasury's return on investment.

In addition, the BVCA is supportive of encouraging more support for early stage businesses, not least in the UK university sector and note with interest the proposals for a new dedicated scheme – BASIS. Seed funding is certainly worthy of support but with the important changes underway in EIS and VCT, we ask for a holistic appraisal of the funding market to avoid duplication and complication. For instance, any moves to focus investment on seed funding should admit angel-like investors which would include professional fund managers who display the sought after characteristics from the angel community.

With respect to later stage venture, it is also hugely important that the impact on conventional LP funds is assessed and policy adapted accordingly. We would consider VC fund participation in EIS to be a must given the increasing proximity and overlap now likely to ensue (please see below). This would extend participation and greatly increase investment into UK SMEs.

Before turning to the specific questions, we would reiterate our welcome to the Budget measures extending EIS and VCTs to include gross assets of up to £15m raising up to £10m over 12 months. We intend to fully support HMT with the evidence base required to get state aid clearance.

2. BASIS

(i) There are a variety of ways in which seed investment in early stage businesses can be supported, including non-tax measures such as a reduction in the burden of "red tape" to such companies (Q2) A standalone scheme, with appropriate tax advantages and accompanying anti-avoidance measures could certainly have significant impact, provided the application process was very simple and avoided unnecessary bureaucracy (Q3). As long as the rules of such a scheme are clearly demarcated and there is a decent degree of "headroom" between BASIS and EIS / VCTs, we do not think that this would be confusing to investors (Q4). However, cost benefit analysis is clearly required to justify a standalone scheme as against say, an extension of EIS.

(ii) Possibly the single largest requirement for seed investments in the UK is the stream of intellectual property coming out of Britain's internationally top-ranking universities. Opportunities are currently assessed and, where appropriate, developed by the technology transfer organisations within the universities. They rely on a varied but

insufficient web of grants, charities and the universities' own funds. As these projects start to mature they are able, in certain cases, to attract venture capital investment and, where the rules permit, (see (iii) below), this finance might come from VCTs and EIS.

At the early stage, however, where finance is required for proof of concept, such funds are scarce.

(iii) In drafting the appropriate legislation, therefore, we believe that the Treasury should include this category of seed investment in their thinking. This is important because, under current VCT and EIS rules university spin-outs are often not eligible as they are majority controlled by another entity (ie. the university). This perfectly reasonable anti avoidance provision is not appropriate, it seems to us, for the sort of seed investment envisaged under BASIS and we would request that there be a carve-out for educational institutions and charities such that they may continue to have a majority holding in BASIS-backed seed companies.

(iv) In terms of definition of "seed" (Q5) we would suggest the following parameters:

1. The business should be pre-revenue from commercial customers, but may have received grants or similar awards (e.g. TSB's recent scheme 'Tech-City Launchpad'). It should also exclude revenue from pilots and consultancy work that may happen in parallel/conjunction
2. The project should either have or be working towards the creation of, its own intellectual property, which may or may not be patentable.
3. The business should have gross assets pre investment of not more than £250,000
4. The company remains eligible for BASIS investment up to the point that its revenues begin or it exceeds the gross asset limit (Q6).

The time-frame for money raised under BASIS would need to be sufficient to (a) fully develop the product (b) start to develop a sales pipeline and (c) follow-on venture finance – this could all take up to three years (Q9).

(v) We support the proposals for the introduction of debt instruments under BASIS as being a useful tool to protect early stage investors from subsequent over dilution (Q11 – 13). The nature of the debt instrument should be kept as flexible as possible in order to provide the greatest degree of protection. As an alternative to the structure outlined, we would recommend consideration of 100% convertible loan stock with the appropriate tax relief provided at the point of conversion, in order to provide greater protection to the angel. Similar thinking should also apply to EIS instruments. It is imperative that we do not divide pools of capital unnecessarily. Investors need every incentive to invest in early stage, but also to follow their money in later rounds.

(vi) As regards the identity and nature of the angels themselves, we understand that BASIS is designed to appeal to quite a different audience from the retail and wealthy private investors who subscribe for VCTs and EIS. However it is important that the role of

venture fund managers is properly understood alongside that of business angels. Fund managers are highly active investors, who provide, mentoring, advice and board participation just as angels do. It is important therefore that any definition used is reflective of that point.
It is also important that we focus on attracting capital so the requirement for an investment 'track-record' should not be onerous

On the assumption, therefore, that the Treasury intends for "angels" to be actively involved in the underlying seed investment, we would propose that angels should be either directors of the underlying company or advisers, or there could be a requirement for investors to have a nominated representative on the board as well a requirement that they have served on another board in a similar sector. We would also, however, recommend that BASIS be open to university academics whose own IPR is in the process of being spun-out (Q14 – 16).

(vii) We would recommend that there is a gap of no less than six months between BASIS finance and EIS or VCT finance (Q19). In terms of monitoring (Q20) an annual return for the first five years following investment, signed by the investee company and the angel, should be returned to HMRC, providing appropriate metrics such as employment and investment (Q20).

3. Simplification

(i) We understand, though do not entirely agree with, that HMT's rationale for excluding those who are connected with an EIS backed company by employment (para 3.14), though we strongly support the proposal in para 3.16. As regards the barrier to price setting mechanisms (Q21-23), we note that under BASIS there is the option of investment in the form of loan stock. If this principle were also applied to EIS investments, this could also help reduce dilution in a practical and cost effective manner – the loan could qualify for EIS at the point it is drawn down, but other EIS conditions apply, such as the need to hold the investment for three years (during which the loan would most likely convert).

What is imperative here is that we have joined up policy, all the way through the funding cycle. Price setting mechanisms such as anti-dilution and convertible equity loans as well as preference shares being EIS qualifying is critical to angels and conventional funds. To support this we need a standard BVCA/EIS term sheet which we are happy to work with HMRC to deliver.

(ii) As regards mergers of the EIS companies, when this is applied to VCT backed investments, the qualification is deemed to continue into the new company either permanently (if the enlarged entity is itself qualifying) or for a limited period of years. We propose that this should also apply to EIS companies (Q24 – 25).

(iii) Section 4.11 and section 4.12 outlines two alternative methods of applying these focus tests. The former is, by implication, subjective whereby the latter is objective and specifies three or more characteristics which need to be failed to resolve disqualification. Of the two alternatives, we prefer certainty and would therefore recommend that 4.12 be applied as an objective list of tests with which qualifying EIS and VCT backed businesses must comply.

Questions 34 to 37 cover acquisition companies and we would support the proposed measures. We would also support the exclusion of certain feed-in tarrif businesses set out in paras 4.16 to 4.21 though the mooted exception for anaerobic digestion is a welcome one.

EIS/LP alignment –EIS Funds, a new class of investor

As set out in the introduction, it is imperative that we join up policy, throughout the funding ladder. At the top end, this means looking at how the extensions on deal size will impact on conventional LP funding. It is imperative that this tax relief is compatible with existing later stage activity. There is an opportunity to raise new money from would be EIS investors using a fund structure and use this to attract further investment from institutional investors providing a significant fillip for high-growth UK SMEs seeking finance.

The extension of EIS and VCTs to incorporate larger deals inevitably brings the worlds of tax advantaged investment and conventional LP funds into close proximity. The merits of using tax advantaged schemes to back larger deals are clear but the mechanics are not. At face value, a £10m EIS deal would require a large number of investors and would likely prove difficult for a company to coordinate.

To avoid distortion and duplication, a framework needs to be devised such that a fund could qualify for EIS relief provided it makes only the requisite investments. Furthermore, there is also an opportunity to, creating a much needed multiplier effect. This will allow larger funds to be raised, and bigger deals to be done. Such funds will be able to support more companies through multiple funding rounds, rather than seeking early exists through trade sales. This could a vital first move in creating the larger funds that can reinvest in multiple rounds, creating a new generation of large UK companies.

The Fund

There are two options to deploy the capital in an EIS Fund.

(i) LP money from institutional investors could be raised alongside EIS money into a fund which would then invest into qualifying companies

(ii) An EIS Fund could act as a fund of funds and invest in conventional VC funds provided they in turn would invest a percentage of their capital into qualifying companies

The fund could have for example, 3 years to invest in 70% qualifying EIS companies/funds (as in VCTs). Tax relief would be given at commitment rather than a deal by deal basis.

In order to achieve this, the following issues need to be resolved:

a) EIS funds be allowed to make commitments to LP funds which make mostly VCT/EIS qualifying investments, rather than only invest directly in companies. a special EIS Limited Partnership could be set up for the purpose
b) EIS funds, as part of the increase in company size and annual funding to £10m per company, are allowed to invest in similar instruments as typical LP funds (the BVCA standard term sheet)
c) EIS funds are allowed to invest alongside LP funds in typical VC investments, and are also able to take a preferred return on their equity risk at the fund level.

APPENDIX 1

Stages of Investment definitions

Seed: Financing that allows a business concept to be developed, perhaps involving the production of a business plan, prototypes and additional research, prior to bringing a product to market and commencing large-scale manufacturing.

Start-up: Financing provided to companies for use in product development and initial marketing. Companies may be in the process of being setup or may have been in business for a short time, but have not yet sold their product commercially.

Other early stage: Financing provided to companies that have completed the product development stage and require further funds to initiate commercial manufacturing and sales. They may not yet be generating profits.

Late stage venture: Financing provided to companies that have reached a fairly stable growth rate; that is, not growing as fast as the rates attained in the early stage. These companies may or may not be profitable, but are more likely to be than in previous stages of development.

Expansion: Sometimes known as ‘development’ or ‘growth’ capital, provided for the growth and expansion of an operating company which is trading profitably. Capital may be used to finance increased production capacity, market or product development, and/or to provide additional working capital.

Bridge financing: Financing made available to a company in the period of transition from being privately owned to being publicly quoted.

Replacement capital: Minority stake purchase from another private equity investment organisation or from another shareholder or shareholders.

Refinancing bank debt: Funds provided to enable a company to repay existing bank debt.

PIPE: Private investment in public companies (minority stake only).

Rescue/Turnaround: Financing made available to existing businesses which have experienced trading difficulties, with a view to re-establishing prosperity.

Management buyout (MBO): Funds provided to enable current operating management and investors to acquire an existing product line or business. Institutional buyouts (IBOs), leveraged buyouts
(LBOs) and other types of similar financing are included under MBOs for the purposes of this report.

Management buy-in (MBI): Funds provided to enable an external manager or group of managers to buy into a company.

Public to private: Purchase of quoted shares with the purpose of de-listing the company.

Secondary buyout: Purchase of a company from another private equity investment organisation.