Invest 2035: The UK's Modern Industrial Strategy: VCTA Response

About the Venture Capital Trust Association (VCTA)

The Venture Capital Trust Association (VCTA) is the industry body representing twelve of the largest venture capital trust managers in the UK.

Our members make up more than 90% of the VCT industry, with £6.5bn funds under management invested through an extensive regional network of local offices across the UK.

We actively campaign to support early-stage businesses during a period of significant economic disruption, helping to create the regulatory landscape to unlock growth capital for scale-up businesses.

About VCTs

Venture Capital Trusts (VCTs) invest in high-growth small businesses, supporting employment and investment across the whole of the UK through the long-standing VCT scheme.

VCTs provide an **essential source of patient capital** to innovative high-growth small businesses, enabling them to access the support and funding they need to grow, enter new markets, and drive employment in all parts of the UK.

VCTs **support early-stage businesses that would otherwise struggle to access commercial investment as they are seen as high-risk investments** and offer intensive business support, commercial and strategic advice in addition to the funds invested.

- VCTA members have made 1,600 individual investments, totalling over £2.95 billion in capital into high growth companies since November 2015, averaging £420 million per annum.
- Over the last financial year, VCTA-backed businesses delivered £21.8 billion in revenues, generating £5.5 billion in exports and investing £274 million in R&D.
- Our investments help businesses to grow fast, helping to tackle the scale up challenge. Mean sales per company increased from £7.3 million to £8.4 million this a year – a 15% year-on-year growth. Since investment, the 2018 cohort of investments have grown sales from £130 million to £455 million – a 3.5x increase.
- Export sales per VCTA-backed company have increased from £0.7 million in 2018 to £1.7 million in 2023

4) What are the most important subsectors and technologies that the UK government should focus on and why;

6) What are the key enablers and barriers to growth in these subsectors and how could the UK government address them; and

11) What are the barriers to R&D commercialisation that the UK government should be considering?

The UK has the potential to be a world leader in innovative, high-tech sub-sectors including life sciences and biotechnology, AI, robotics and deep tech. We also have a significant financial services sector which is making rapid strides into new and exciting areas, including state of the art cyber security and innovative new payments solutions.

One of the most important things the UK can do to enable growth in these sub-sectors is to support the Venture Capital Trust (VCT) industry and the Enterprise Investment Scheme (EIS), which together provide patient equity capital to thousands of SMEs every year.

Many early-stage, high-growth small businesses struggle to access funding because they are high risk investments. This is especially true for research intensive businesses such as those in these sub-sectors. VCTs address that market failure and help to close this gap in the funding landscape through attracting private investors by means of the tax benefits, which help to offset the risk. Patient capital is locked in by the need to hold the investment for 5 years to retain the upfront tax relief – and as noted above, more than nine in ten investors hold their investment for longer than this.

VCTs are able to provide evergreen patient capital, which means they can remain invested in companies for many years. This is possible because the structure of VCTs means that individual investors are, after an initial lock-in period of five years, able to sell their investment without the whole fund having to be liquidated. Because VCTs are evergreen funds, the initial 30% income tax relief not only leverages the additional 70% of private capital, but this sum can grow and be re-invested multiple times by the fund into new eligible businesses across the UK. Moreover, only around 7% of investors sell once the 5 year minimum hold is up - the average investment term is therefore significant. This combination of an evergreen fund structure and recycling of capital has meant that VCTs have had capital to invest through cycles and – importantly in times of greatest economic need – when fundraising may be more challenging.

However, VCTs could be empowered to do even more to support the innovative, high-tech companies that have the potential to make significant social impact and become the unicorns of the future.

VCTs are ideally positioned to help these innovative companies, which need investment to grow and undertake cutting edge research, over the course of their life cycle.

However, for VCT funding to have the impact the scheme was designed to deliver in these high-tech sectors, the annual and lifetime limits of the scheme, and also other limits including the gross assets test, need to be raised to reflect current economic circumstances.

Currently, the annual limits for VCT investee companies are £5m (£12m for Knowledge Intensive Companies) and the lifetime limits are £12m (£20m for Knowledge Intensive Companies).

The annual and lifetime limits have remained static despite rapidly rising inflation and therefore have not kept pace with the investment needs of innovative, fast growth companies – especially those in sectors like life sciences, which tend to require greater capital over time.

To adapt the lifetime limits to better suit our present economic environment, the VCTA believes that annual limits should be increased to £6.5m (15.5m for Knowledge Intensive Companies) and lifetime limits should be increased to £16m (£27m for Knowledge Intensive Companies), with a commitment to review these levels every three years, with a report published to Parliament. These updates would be in line with inflation, based on CPI data from the Bank of England showing 31% inflation since 2015. If the investment limits are not increased in line with inflation, the VCT industry's investment power will effectively soon be eroded to only half of what it was in 2016. This hindrance could easily be removed.

As a general rule, we believe it is right that all monetary value limits on the VCT scheme – for example, the gross assets test – are reviewed every three years alongside the levels of the annual and lifetime limits and are accordingly increased in line with inflation.

7) What are the most significant barriers to investment? Do they vary across the growth-driving sectors? What evidence can you share to illustrate this?

In addition to the annual and lifetime limits on the VCT scheme, VCTA research compiled for the previous government's Taskforce on Innovation, Growth and Regulatory Reform in 2021 found that the current VCT scheme age limits effectively discriminate against businesses seeking VCT investment in regions and nations outside of London and the south east. This means that businesses in growth-driving sectors are placed at a disadvantage if they are based in other regions or nations around the UK.

Data from our membership, which comprises 90% of the VCT industry by value, shows a significant differential in the age of a business at the point of investment between Greater London and the rest of the UK: those businesses based outside of London take longer to mature, particularly those in manufacturing industries, those that were most heavily impacted by Covid-19, and those which are research intensive.

While there is significant variation between regions, our analysis still clearly demonstrates a differential on age of business when considering Greater London (5.1 years) vs. Rest of UK (7 years). This means that many businesses in the regions, by the time they are considering VCT investment, are already too late unless they are classed as Knowledge Intensive or have prior EIS investment.

The VCT sector appreciates the need for more investment in businesses and entrepreneurs outside of London and the South East, and the VCTA is focused on how we

can enable VCT funds to invest in more businesses in the regions. However, as things stand, the current age limits preclude otherwise ideal candidates for VCT investment from consideration, because they are based in the regions and consequently reach the stage where VCT investment is suitable at a later stage than businesses in Greater London.

The age limits for businesses accessing VCT funding are, respectively, 7 years for general investee businesses and ten years for businesses that are classed as Knowledge Intensive.

To make it easier for VCT funds to invest in innovative, fast-growing businesses in the UK's regions and nations, we propose raising the age limits to 10 (from 7) years for businesses accessing VCT funding, and 13 (from 10) years for Knowledge Intensive businesses.

We also believe that a number of other age-related limits within the VCT scheme prevent investments in companies which meet the aims of the scheme. The rules should be amended – within the EU State Aid framework – so that VCT investment is targeted more effectively. This would ensure that companies which meet the policy objectives are not prevented from raising VCT funding by technical constraints not included in the EU State Aid rules.

Amending the age limit test would also be an opportunity to look at ensuring the Knowledge Intensive Companies proof process is fit for purpose. Given its relevance for how the age limit test is applied, the government should look at reforming this to make it more logical for practical application.

The two amendments to the age limit test which would make the most positive impact on the operation of the VCT scheme are outlined below.

Firstly, at present the UK VCT rules on the age limit for qualifying companies are stricter than EU regulations.

The EU applies the age limit test (as above, 7 or 10 years, depending on the type of business) to the 'first commercial sale' that a company makes in a certain market. By contrast, the UK legislation requires consideration both of the date of the first commercial sale of the business activity, and the age of the legal entity when this sale was made.

This means that many companies which clearly meet the policy objective of the EU guidelines on State aid risk finance are being prevented from receiving VCT funding because of this additional test applied by the UK rules.

This presents frequent difficulties when a business has entirely ceased an old business activity and started a new one. The commercial reality is that this new activity is effectively a new business, with all the risk that involves, but the way the UK rules are currently applied does not recognise this.

The age limit test should therefore be applied to the activity rather than the company. Bringing the test in line with the EU regulations in this way would increase the number of businesses which meet the policy objectives of the VCT scheme, thereby unlocking greater investment into potentially high-growth UK businesses who lack access to finance.

Example: A company originally established by an individual to provide consultancy services is, after several years, then used as the vehicle for building a high-growth entrepreneurial business. The EU guidelines only apply the age limit test to the entrepreneurial business, whereas the UK rules apply it to the company.

Delivering the change

Delivering this change would require an amendment to legislation. The age condition is provided for by both section 280C and 294A of the Income Tax Act 2007. Both sections were inserted into the 2007 Act by the Finance (No. 2) Act 2015.

Secondly, complications arise when a potential investee company – which would meet the age limit test outlined above – is part of a corporate group.

If one of the other companies in the corporate group is too old, the potential investee company cannot receive VCT investment. This is the case even if the company which is too old is no longer part of the corporate group.

This is sensible as an anti-tax avoidance measure (for example preventing a situation where an old company is incorporated into a new one to avoid the age limit test), but it has unintended consequences that prevent companies which would genuinely be eligible from receiving VCT investment.

The origin of this problem is the reference in the UK's legislation to "imported trades." This is not included in the EU's guidelines.

To correct this, we are suggesting that a 'materiality test' should be applied to the company in the group which is too old. If this older business represents less than 20% of the activities of the group at the point of investment, the investment should be allowed to go ahead. This would unlock greater investment into potentially high-growth UK businesses who lack access to finance.

22) What are the main barriers faced by companies who are seeking finance to scale up in the UK or by investors who are seeking to deploy capital, and do those barriers vary for the growth-driving sectors? How can addressing these barriers enable more global players in the UK?

In January 2023, the VCTA published research after surveying 240 senior decision makers in charge of recently launched small businesses less than seven years old and employing up to 250 employees. The VCTA's study highlights the crucial role played by equity finance in helping early-stage businesses to grow: two-thirds (66%) of respondents believe that increasing the availability of venture capital finance would make the biggest difference to supporting entrepreneurs looking to start or grow a business. This is comfortably ahead of other factors including access to local skilled staff (48%) and better local transport links and infrastructure e.g., broadband (34%).

Despite an overwhelming majority (92%) of respondents requiring equity finance over the coming two years, almost half (44%) say their main barrier is that they lack information on

how to access it, the figure rising to 47% among entrepreneurs based outside of London and the South East of England.

This is something that the VCTA is looking to combat through our ongoing initiatives to reach out to investment communities in regions and nations outside of London and the South East to hold roundtable events with local entrepreneurs, researchers and political decision-makers to raise awareness of the benefits of the VCT scheme. To date, we have held an event in Sheffield with Clive Betts MP and an event in Manchester with Josh Simons MP – and plan to hold further events in Birmingham, Wales and Scotland.

VCTA members also co-invest in places with the British Business Bank. The British Business Bank's role in the deployment of capital into the regions, e.g., through the Northern Powerhouse Investment Fund (NPIF) and Midlands Engine Investment Fund (MEIF) is important. This combined with schemes like EIS and VCTs attracts capital into the regions, which helps to develop self-sustaining environments for business growth and job creation. As the MEIF and NPIF are typically limited to £250k-£2m investments, VCTs have an important role to play as growing start-ups look for investment in the £2m-£5m range.

We would recommend that the government explore how it can work together with the private sector and organisations like the VCTA and British Business Bank to help ensure entrepreneurs and businesses are aware of how they can access growth finance.

However, while it is a significant problem for some innovative businesses, lack of awareness about how to access growth finance is not the only barrier. The issues with the VCT age and lifetime limits, as we have set out in our earlier answers, are the most significant barrier to our industry directing more investment into high-growth, research intensive companies, especially in regions outside of London and the South East of England.