Venture Capital Trusts

Bridging the funding gap for UK SMEs

VCTA
Venture Capital Trust Association

Introduction

The extensive benefits of Venture Capital Trusts (VCTs) to the UK economy have been much discussed and detailed over the past few years.

In 2021, VCTs invested £538.5 million in new and follow-on investments in small, private businesses. Throughout the recent pandemic, £1.1 billion was invested; over 1,100 companies across the UK currently benefit from VCT funding.

VCTs have helped develop and support a thriving start-up and entrepreneurship community in the UK, an ecosystem recognised around the world. These high growth businesses play a crucial role in stimulating our economy, punching above their weight in terms of innovation, productivity and job creation.

As part of the VCTA's ongoing campaign to understand the needs of SMEs, we commissioned independent research among senior decisionmakers at 240 VCT-qualifying businesses[1] across the country. The research focused on the challenges they face, barriers to growth and funding needs.

> “VCTs have helped develop and support a thriving start-up and entrepreneurship community in the UK”

The study found that while the vast majority of SMEs need and value equity finance, the top barriers to accessing external finance from SMEs are:

- Lack of information on available sources of finance
- Company valuations
- Insufficient track record
- A clear business model

VCTs are well positioned to address these barriers. As a vehicle for driving start-up and entrepreneurship, VCTs invest into young businesses that lack a track record or clear business model, reasons that would impact their ability to obtain funding elsewhere. VCTs also have a proven history of agreeing on valuations. The lack of information on sources of finance suggests that an ongoing education exercise is required across the industry and, for VCTs specifically, the work of the VCTA is to precisely bridge that knowledge gap.

The findings reinforce the pivotal role that VCT funding plays in providing equity finance and strategic counsel to nurture early stage, high-growth companies which, due to their high-risk profile, struggle to obtain financial support from other sources such as banks.

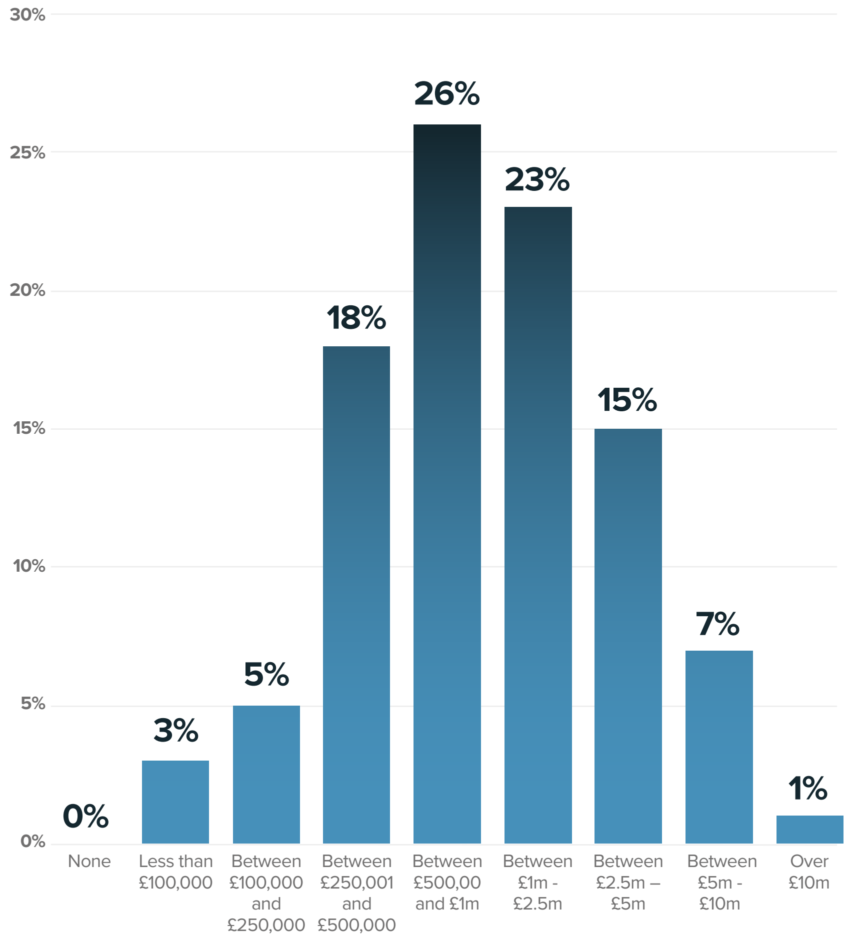
1 Research was conducted among a sample of 240 senior decision makers at UK SMEs in August 2022. Respondents were split evenly by the 12 UK regions and by headcount (1-9, 10-49 and 50-249). All respondents fit the criteria for VCT investment, with responding businesses having been trading for an average of 3.5 years and having total gross value of assets standing at £7.2 million.

Successful UK firms need suitable finance

The vast majority of firms we surveyed want to raise finance. They need the support that VCTs offer. Our study found that 96% have sought to raise finance over the past two years, with less than two thirds being successful.

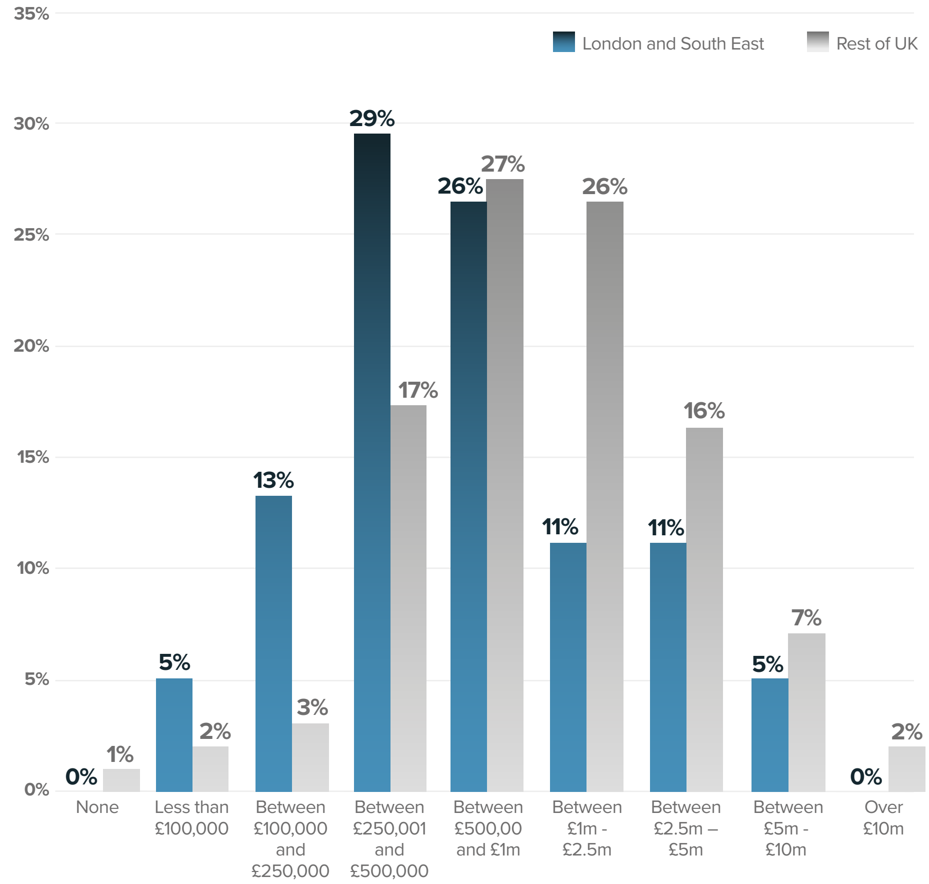
Significantly, all of them say they will need equity finance over the coming two years, with an average amount of £1.88 million being required.

How much equity finance do you believe your business will need over the coming two years?



According to the study, businesses outside London and the South East require a slightly higher amount of equity finance, with the average standing at £2.04 million. This compares to £1.3 million in London and the South East[2].

How much equity finance do you believe your business will need over the coming two years?



These sorts of sums – between £500,000 and up to around £2 million – are the historic sweet spot for VCT funding.

VCTs have consistently found strong demand among entrepreneurs, many of which have gone on to rapidly scale their businesses. With the UK government's drive for growth, these young, dynamic firms occupy a significant market niche that will continue to require hands-on support. VCTs typically provide larger equity investments than the Seed Enterprise Investment Scheme (SEIS) and Enterprise Investment Scheme (EIS).

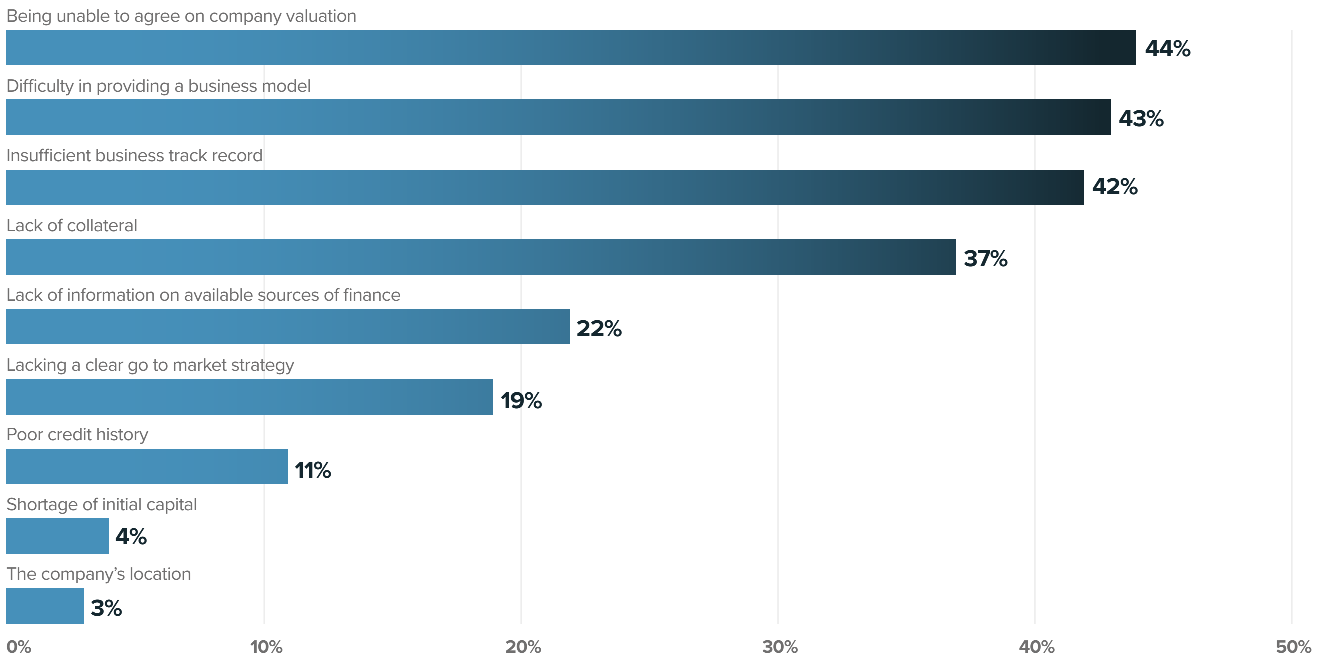
2 Higher amount may be due to the fact that responding businesses in the rest of the UK were larger in terms of their gross value of assets (£7.36m) than those based in London and the South East (£6.44m).

Traditional barriers to finance

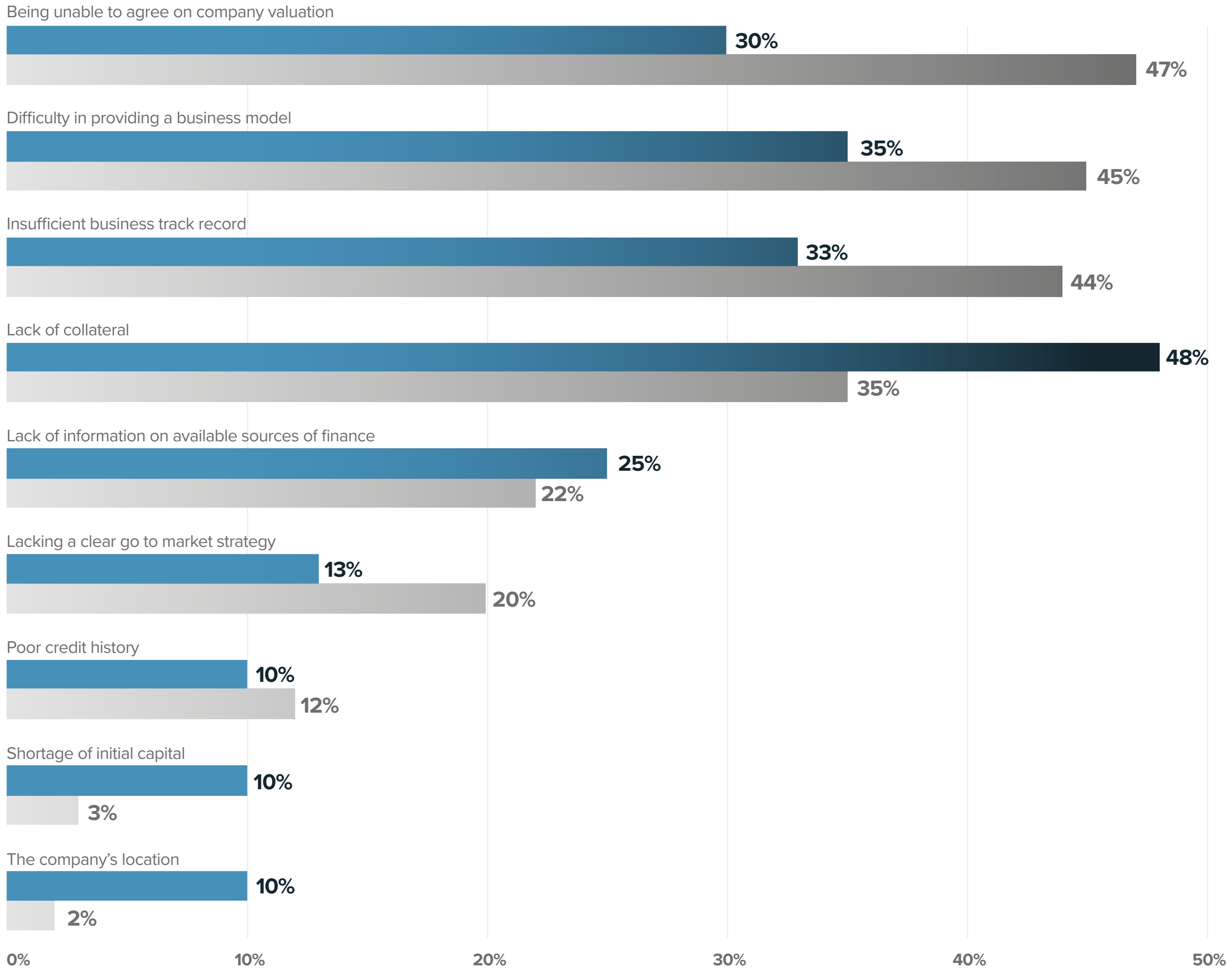
Despite this market need, it is clear that challenges remain for many firms that know they need finance and support but don't have the knowledge, track record, network or confidence to capitalise on their ambitions.

The greatest barrier to accessing external finance is a lack of information on the available sources – cited by 44% of respondents. This is roughly on a par with being unable to agree on company valuation (43%) and an insufficient business track record (42%).

What do you consider to be the main reasons that make it difficult to access external finance?



What do you consider to be the main reasons that make it difficult to access external finance? (Regional)



A lack of information about suitable sources of finance is a challenge that must be addressed as a priority by the wider financial services and investment community - including VCT providers themselves.

Nevertheless, VCTs are ideally qualified to help business owners overcome their perceived barriers to finance.

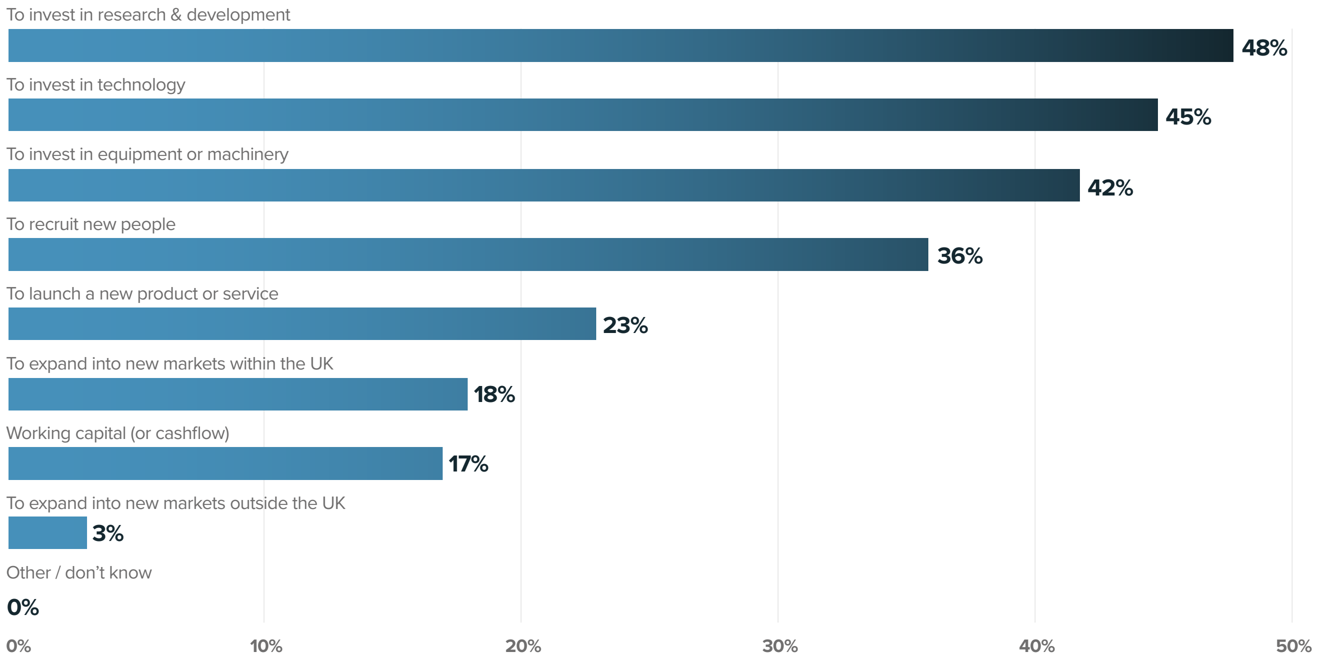
VCTs focus less on criteria such as long-term track records and company valuations and more on factors such as product innovation, market disruption potential, ambition and growth potential. VCT managers take a far more holistic approach and specialise in identifying businesses with growth potential, while recognising that considerable hands-on support and guidance is required for them to navigate the journey successfully.

Bridging the funding gap for UK SMEs

Research & Development, technology and jobs

How the UK's fast-growth, capital-hungry businesses use finance illustrates just how necessary providing the right support is: the biggest reasons for looking to raise equity finance is to invest in Research & Development (48%), technology (45%), and equipment and machinery (42%).

What are the reasons for you considering raising equity finance?



VCTs have an excellent track record of stimulating well-paid jobs in innovative, fast-growing industries across the UK, delivering on the government's intention to level up regional economies outside of London and the South East. For example, the average salary for an employee at an unquoted, VCT-backed company in the North West of England is approximately £40,000. This is nearly £10,000 higher than the whole-region average wage. Amongst quoted VCT-backed companies in the North West, the average salary rises to £50,000.

40k unquoted

50k quoted

The companies currently supported by VCTA members employ 72,404 people, predominantly across the UK. The average salary of unquoted VCTA companies was £49,255 in 2021 – significantly higher that the UK average salary of £38,131 for full-time employees.

£47,975
average salary of unquoted VCT companies

£38,131
full-time employees UK average salary

R&D, in particular, is a critical element of the future competitiveness of the UK and our collective economic strength. That it is top of mind for entrepreneurs is a testament to their ambition to break the mould, and is also a huge opportunity for investors.

36%
Recruitment

23%
launching a new product

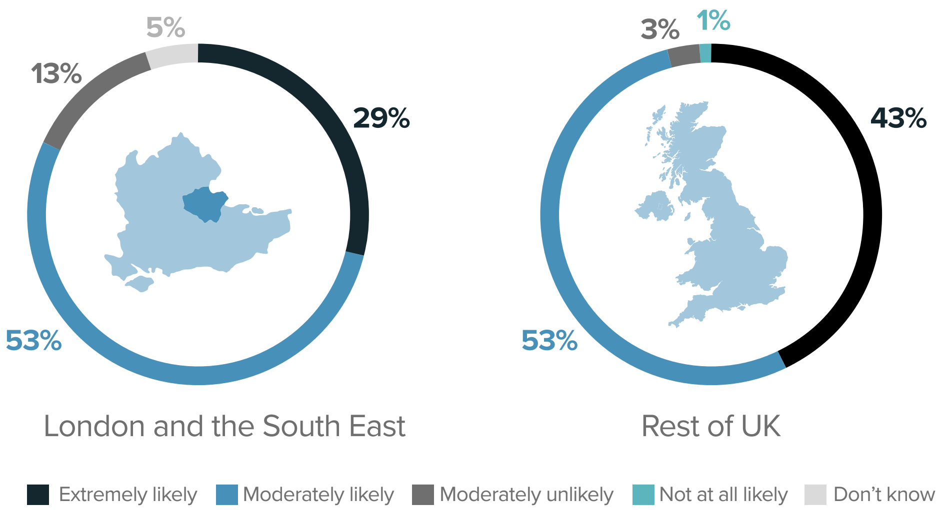
18%
expanding into a new market

Recruitment was selected by over a third of respondents (36%), ahead of launching a new product (23%) or expanding into a new market within the UK (18%). All these reasons demonstrate a pro-growth mindset rather than that of 'keeping the lights on' through funding existing operations which is critically important when deciding which companies to back.

The role of VCTs in meeting the market need

We used this study as a reason to explain to the businesses that took part how venture capital funding works and the benefits it can offer qualifying businesses.

How likely would you be to consider raising this equity finance through a Venture Capital Trust?



Once they'd been told about it in more detail, more than nine in 10 firms said they would consider raising equity finance through a VCT over the coming two years, with 40% viewing this scenario as "extremely likely".

Businesses outside of London and the South East are more likely to consider raising equity finance than those in and around the capital, with more than two fifths stating that they are "extremely likely" to do so – compared to under a third of those based in London and the South East.

SMEs likely to raise equity finance through a VCT

82% London and the South East

96% Rest of UK

Conclusion

Not all VCT investments succeed in delivering returns to investors. They are not without risk, which is why the government provides tax advantaged money to encourage and leverage capital from private investors. However, the majority of investments have a successful impact on the firms they invest in – benefitting not just the firms and their owners but employees, investors and the UK economy.

Over the past three years, unquoted, VCTA companies have increased sales by 62.5%. Exits from successful VCTA backed businesses have valued those businesses at £7.6 billion in 2021.

As our study has found, VCTs fulfil a market need for dedicated funding to help early-stage firms grow, innovate and succeed. They represent vital support for vital firms.

We strongly believe that VCTs should continue to be backed by the UK government and we are delighted that it has been confirmed that they will be extended beyond 2025 (the so-called 'sunset clause' built into the 2015 Finance (No.2) Act).

> "VCTs fulfil a market need for dedicated funding to help early-stage firms grow, innovate and succeed"

About the Venture Capital Trust Association

The Venture Capital Trust Association (VCTA) is the industry body representing twelve of the largest venture capital trust managers in the UK. Its members make up more than 90% of the VCT industry, with £6.1bn funds under management invested through an extensive regional network of local offices across the UK.

It is an industry body actively campaigning to support early-stage businesses during a period of significant economic disruption and create the regulatory landscape to unlock sufficient growth capital to accelerate the UK's recovery.