Venture Capital Trust Association

Response to Labour review of UK start-up activity

About the Venture Capital Trust Association

The VCTA represents thirteen of the largest Venture Capital Trust (VCT) funds across the UK, which together represent more than 90% of the VCT industry by value.

The businesses we support range across sectors as diverse as digital technology, medicine development, specialist manufacturing and online retailing.

The thirteen funds we represent are Octopus, Gresham House, Albion Capital, Foresight Group, Downing, Beringea, Mercia, Maven Capital Partners, YFM Private Equity, Canaccord Genuity, Molten Ventures, Pembroke VCT and Puma Investments.

What is a VCT?

Investments in VCTs carry tax relief to encourage retail investors to support smaller, higher risk companies who would otherwise not invest in such companies. VCTs are investment companies which pool investments with those of others, allowing investors to spread their risk over a number of small companies.

VCTs invest throughout the UK, helping to balance the nation's economy, and as VCTs support businesses that are growing rapidly through the development of their management teams and operational functions, VCTs help create employment at all levels within a business.

1. What more can we do to ensure new and growing businesses have access to capital, and in particular patient capital?

– Where are the gaps in the current funding landscape? (e.g., by stage of funding, by type of firm, by sector).
– Are the current set of institutions (e.g., British Business Bank and British Patient Capital) right, and do they have the right mandates?
– What regulatory and policy changes could be made to encourage deeper provision of patient capital in the UK?

One of the most important things the UK can do to ensure that new and growing businesses can access patient capital 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. The urgent and crucial action needed now is to remove the 'sunset clause' built into the *2015 Finance (No.2) Act*, which as the situation stands, will leave SMEs hoping to receive patient capital funding from VCTs or EIS unable to do so after expiry date of the schemes in April 2025.

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.

Many early-stage, high-growth small businesses struggle to access funding because they are high risk investments. 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.

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.

It is the complementary nature of the VCT scheme, the EIS and the Seed Enterprise Investment Scheme (SEIS) together that makes the UK such a successful place to start and scale a business. SEIS allows for very early stage, whereas VCT and EIS work alongside each other – they can only invest in the same kinds of opportunities with the same maximum size and age limits. However, they typically appeal to different types of investors and VCTs often invest larger sums.

By virtue of the fact that a VCT operates as a fund, investors receive a share of all the investments held by the VCT when they invest. This provides a diversified investment (albeit focused on early-stage companies) from which a less volatile return might be expected.

EIS requires investors to invest directly into the shares of one or more early-stage companies which investors will then hold until there is an exit event. EIS tax reliefs are more generous overall due to the availability of loss relief for non-performing investments, which recognises the fact that losses and growth will be offset within a VCT itself.

Both investments tend to be held over a long period by investors, but with EIS there is typically no option to remain invested after an exit event has occurred. VCTs typically appeal to slightly less experienced early stage investors because diversification can be achieved from lower investment values, and they have more straightforward administration.

Crucially, at the stage of a small business's development where they are seeking investment to grow, VCT fund managers also provide integrated business support and advice that is bespoke for each business to help the entrepreneurs scale their companies faster, by developing new products, entering new markets, and creating new jobs. Experienced VCT managers have a network of specialists who can help investee companies scale and grow, for example advising how to hire and build effective management teams, supporting overseas expansion, or to develop effective sales and marketing strategies. VCTA member firms are represented as Board members or Board Observers on over 70% of all VCTA backed companies, providing professional, intensive support and guidance over the long term.

The VCT scheme was established at the same time as the EIS, and both, alongside SEIS, are essential rungs on the funding ladder for start-ups looking to scale. Since their establishment , the schemes have had cross-party support and the demand for, and success of, the SEIS, EIS and VCT schemes has been consistently noted by a series of independent reports over the last five years.

We believe that more can be done to increase the pool of high growth and scalable companies to the benefit of the UK economy. SEIS targets the very early-stage investments, and recent statistics published by the government show that 2,065 companies raised a total of £175m between 2020 and 2021. Allowing companies at the very earliest stage to raise more funds would improve their prospects of success, and therefore we support the EISA's position that increasing the cap on the amount a company can raise under SEIS from £150,000 to £250,000 would provide that additional early-stage investment. The VCTA supports the idea that more money going into the SEIS is one way that more funding could go into the sector as a whole, and encourage more start-ups.

Most importantly, the VCT scheme and EIS are working well, and we strongly believe that both schemes should continue to be backed by the UK government with the 'sunset clause' built into the *2015 Finance (No.2) Act* extended, or preferably amended to place the schemes on a permanent footing, so that they can continue to deliver essential patient capital to high-growth start-ups beyond 2025. The industry needs certainty that the schemes have a future beyond April 2025; without this, raising money into a VCT may rapidly become challenging from a governance perspective, due to the risk of bringing investors into an illiquid fund without the means to create liquidity or continue to invest and grow.

Entrepreneurs and VCT-backed businesses require certainty for long term investment, especially when the nature of patient capital means that businesses require support from VCT investors for an average of seven years (as shown by VCTA data).

The ability of VCTs to raise additional capital has been an increasingly important part of supporting early-stage businesses to scale. The continued availability of capital resulting from this ongoing fund raising means that entrepreneurs can receive additional funding to support the continued growth of their businesses.

The Industry Panel response to the Patient Capital Review (PCR) in 2017 endorsed this, finding that follow on funding was important in "smoothing the transition from EIS / VCT funding to venture". The Panel suggested encouraging "follow-on investments, [which] could help smooth the transition into non-tax-incentivised investments."[1] The PCR also recommended extending the VCT scheme and EIS.

Since the PCR, the value of follow-on investment per annum across the whole industry increased from £88.3m in 2017 to £197.8m in 2021, as businesses sought increasing investment to support their ambitious plans. There is therefore a significant latent demand within existing portfolio businesses for further tax-incentivised capital, in addition to the need for new businesses to access VCT support for the first time (between £235-334m per annum between 2017 and 2021).

[1]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/661397/PCR_Industry_panel_response.pdf

However, built into the *2015 Finance (No.2) Act* is a sunset clause, which states that eligibility for VCT and EIS tax relief will only apply to shares that are issued before 6 April 2025. Unless the sunset clause is amended or removed, it also means that the last time new shares can be issued to subscribers who will still be eligible to claim VCT income tax relief is 5 April 2025. This would mean that no new capital would be raised after this point, because the tax break is essential in raising further money for the VCT and EIS schemes. The sunset clause was inserted as it was a requirement under EU state aid rules; now that the UK has left the EU, removing the clause represents an opportunity to make the best of the UK's post-Brexit regulatory environment and support our start-up ecosystem.

Removing the sunset clause would be the most impactful way to improve the effectiveness of the VCT scheme and of EIS, placing the schemes on a permanent footing and providing entrepreneurs with confidence that they will continue to be able to receive VCT and EIS funding beyond 2025.

2. Do we have the right incentives for growing businesses in the UK, and how do they compare to other countries?

- How does the tax system incentivise growing businesses - in particular are there complexities or contradictions that limit this?
- Outside of the tax system, how could policy or institutional features be changed to provide greater incentives?

The UK is a great place to start and grow a business and is helped by tax-incentivised investment through schemes such as the SEIS, EIS and VCTs. These have helped to develop a thriving start-up community recognised around the world, providing financial support at the earliest stages of starting a business by encouraging investment in small, unquoted trading companies. A 2019 report[2] collating data on general economic factors from the World Bank, World Economic Forum, UNESCO, OECD, and tax consultancies ranked the UK as the second-best country in Europe for start-up businesses.

These high growth small businesses are the engine of the economy, growing rapidly to punch well above their weight in terms of their economic contribution, productivity, and job creation. They are not without risk, however, which is why the government provides tax incentives to encourage investment by private individuals.

Significant sums have been raised from the UK's retail investors through the schemes. In 2021, VCTs invested £668.6m in new and follow-on investments in UK-based small private businesses and Alternative Investment Market (AIM) companies. VCTs are also able to support businesses during times of economic hardship, when other sources of capital are harder to access: throughout the recent pandemic, £1.2 billion was invested in UK SMEs by VCT funds.

VCTs, EIS and SEIS are established programmes that resonate well with investors and the entrepreneurs in whom they invest. They play a vital role in providing a continuous ecosystem from early-stage funding for companies, from angel investing, through to non-tax incentivised venture capital.

As the PCR found in 2017, the "popularity of these schemes has contributed significantly to the development of a vibrant UK start-up scene." That review led to the tax incentive schemes prioritising knowledge intensive companies undertaking research and development, thus strengthening the ability of these innovative high growth small businesses to access the incremental capital they need to develop their businesses.

The Future of Growth Capital Report, published by the Scale Up Institute in 2020, found that "approximately 80% of total investment in angels' investment portfolios were made through these [EIS and VCT] schemes in 2015[3], and the British Business Bank's Angel Market research report of 2018 revealed that 86% of total investment in angel investment portfolios were made through these schemes in 2017"[4].

The Kalifa Review of UK Fintech, commissioned by the government and published last year, found that this popularity has not waned, with a survey showing that "97% of founders have used tax-incentivised investment schemes including EIS, SEIS and VCT." Separately, the Taskforce on Innovation, Growth and Regulatory Reform[5] published a series of recommendations calling for the VCT scheme to be expanded to unlock investment outside of London and the South East as part of the government's levelling-up agenda.

Independent parties including the British Business Bank, the UK BioIndustry Association, Innovate Finance, Coalition for a Digital Economy (COADEC), the UK Business Angels Association (UKBAA), the ScaleUp Institute and the Institute of Chartered Accountants in England and Wales (ICAEW) voiced support for the schemes in their submissions to the recent Treasury Select Committee inquiry into the venture capital market.

Both entrepreneurs and independent experts hugely value the schemes as an important part of the UK's funding ecosystem. As highlighted in our answer to question one, a significant risk to entrepreneurs' access to tax-incentivised EIS and VCT investment is the 2025 sunset clause on the schemes. The removal of the sunset clause would give entrepreneurs and SMEs confidence that they will be able to continue to receive investment beyond the current expiry date of the schemes in 2025.

3. Do universities have the right skills, structures and incentives to allow them to successfully spin out and grow businesses?

– How well are universities set up to encourage spin-outs and the commercialisation of research?
– How can government help ensure universities have the right ecosystem of investor networks, firms, and leaders, and the right structures to spin out businesses?
– How should universities build enterprise into their institutions and recruitment processes?

Last year saw record investment in UK university spinouts, totalling £2.53bn[2]. This reflects a 69%[3] increase on 2020, which was then also a record high investment total. There is also a positive upward trend the number of deals; 2021 marked the second highest number of spinout deals recorded in a year[4].

The UK's spinout sector is in an increasingly robust position, and VCTs have an important part to play in investing in university spin outs. VCTA members have invested in university spinouts including Fertility Focus, which has its roots in the University of Bristol, and

[2] The Royal Academy of Engineering Spotlight on Spinouts report, 2022
[3] ibid
[4] ibid

whose OvuSense range of retail fertility monitoring solutions last year launched the first ever skin-worn fertility sensor for women looking to conceive naturally.

CASE STUDY: FERTILITY FOCUS

Fertility Focus, a spinout from the University of Bristol, is a fertility monitoring technology company that has developed OvuSense, a registered medical device that enables consumers to predict ovulation and thereby aid conception.

In early 2019, VCTA member Foresight Group announced a £1.25m growth capital investment into Fertility Focus, leading a £2m funding round. A strategic partner since this initial investment, Foresight has made three investments into Fertility Focus, after a second round of £600k in December 2019 and a third round of £500k in August 2021 to support further product development.

In June 2021, Fertility Focus announced the launch of a new product, OvuFirst, a completely unique patented sensor designed to measure skin temperature, providing women with an understanding of when to try and conceive naturally, and enabling them to determine what issues they may have trying to conceive.

Joining the OvuSense fertility monitoring family, which now supports couples from their first months trying to conceive right the way through to monitoring clinical treatment, OvuFirst is targeted at women who wish to monitor their ovulation and cycles in a convenient, non-invasive way. By wearing the clinically-proven sensor on the arm or wrist overnight OvuFirst confirms a woman's fertile window with over 90% accuracy even if she has irregular cycles – making it the most accurate skin-worn sensor on the market. The OvuSense App then uses this information to provide women with a full 8-day fertile window at the start of their next cycle.

Fertility Focus CEO Robert Milnes commented, "We are proud to offer a convenient and easy-to-use solution to assist and support women during the early stages of their fertility journey, whether that is trying to start a family, or simply learning more about their bodies and cycles. There are so many people within our organization, as well as with tremendous partners such as Foresight Group, who have not only encouraged but participated in our company's growth and exciting trajectory for helping women conceive."

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This position of the university spinout sector will continue to evolve over time as the volume of spinouts and deal flow increases, and new models continue to develop to meet the unique opportunities that will arise. As of January 2022, there were 1130 spinouts, of which 28% (313) are at venture stage. The majority of active spinouts (59%, or 672) are at seed-stage[5]. This indicates a thriving pipeline for future spinout growth, and reflects that universities are growing in experience and skill at identifying and nurturing potential spinouts. It also reflects that in the coming years, there will be a growing number of spinouts which meet the criteria for VCT investment – especially as VCTs prioritise knowledge intensive companies undertaking research and development.

VCTs and the EIS are important parts of the funding ecosystem for small businesses looking to grow, and unless the 2025 sunset clause is removed, there will be fewer

[5] ibid

opportunities for university spin outs to access the patient capital they need to help them scale.

4. How do we improve access to public procurement for start-ups?

– What are the barriers to start-ups accessing public procurement?
– How could policy reduce these barriers and/or actively prioritise high-growth British businesses in procurement decisions?

A significant issue for start-ups seeking to win public contracts is that application processes can be very complex, which can put off first-time applicants. Requests for proof of specific certifications not outlined at the beginning of the tender process, and requirements that organisations bidding for contracts provide company policy documents that most large companies will have but many SMEs will not, can lead to start-ups abandoning the tender process entirely if they do not have the proper support.

Greater upfront warning for companies about what the tender process will require would go a long way to helping resolve these issues, as it will give SMEs more time to prepare and ensure they have the right certifications and policies in place, and that they will be able to meet the technical requirements of the contract.

VCTs are also well placed to give their portfolio companies expert advice and support on applying for public contracts. In addition to providing patient capital, VCT funds have a network of specialists and business experts who can help investee companies navigate public tender processes, for example by advising them on how to produce company policy documents that demonstrate they meet the requirements of the tender and make sense for an SME.

5. How do we ensure we have a better geographical distribution of start-up high-growth businesses across the UK?

– What are the key barriers to wider geographical distribution?
– Can better distribution be achieved through central policy, or should it focus on (setting up) empowering local institutions?

VCTA member funds are invested and managed by independent fund managers through an extensive regional network of more than 20 local offices in towns and cities around the UK, supporting growth in all parts of the country. In having investment professionals located across the UK's regions and nations, they can be closer to the companies in these areas in which they invest and therefore gain a better understanding of their needs and focus on investing in those areas. Local presence is also an effective way of ensuring that the availability of patient capital is well known and understood by local entrepreneurs.

VCTs have an excellent track record of stimulating well-paid jobs in innovative, fast-growing industries across the UK. Of the 50,844 jobs at VCTA-backed businesses across the country, 37,319 are based outside of Greater London. This includes:

- More than 1.3 thousand jobs in Scotland;
- More than 1.7 thousand jobs in the West Midlands;
- More than 8.7 thousand jobs in the South West;
- More than 4.8 thousand jobs in the North West;
- More than 4.4 thousand jobs in the East Midlands;
- More than 5.7 thousand jobs in the North East;

In addition, across every UK region and nation, the average salary for an employee at a VCTA-backed business is higher than the average salary for all full time employees in that region/nation. As average salary is used as a proxy for productivity by the British Business Bank, among others, this also reflects a boost to productivity across the UK's regions and nations.

Region/Nation	**Average VCTA-backed business salary, GBP (source, VCTA annual return)**	**Average salary in region for full time employees, GBP (source, Statista)**
Greater London	58,000	39,716
South East	47,219	32,810
Scotland	44,781	31,672
East of England	52,256	30,867
West Midlands	40,854	30,000
South West	42,813	29,080
North West	38,896	29,529
Northern Ireland	61,940	29,109
Wales	31,838	28,506
East Midlands	52,688	28,416
North East	35,446	27,515
Yorkshire and The Humber	35,088	28,808

Since the rule changes to the VCT scheme in 2015, VCTs have focused on seeking out high growth areas of the economy, including specialist manufacturing, data analytics, digital security, health tech, automation and FinTech. Our focus on growth sectors of the economy extends to growth regions – the Kalifa Review of UK FinTech recommended supporting regional specialisms and nurturing the growth potential of the UK's top ten FinTech clusters to maintain the UK's status as a FinTech hub, and by design the VCT scheme is ideally positioned to offer much needed patient capital to fast-growing start-ups in those regions.

However, there remain greater challenges for start-ups based outside of London and the South East. One such barrier that we are seeking to address is concerns that there may be less awareness of schemes like VCTs across other areas of the country. Anecdotally, our members have observed that fewer start-ups in the regions seem to have been advised of their eligibility for VCT funding, in comparison to start-ups founded in London. It may be that this is an issue derived from ecosystems of investor networks and business advisers being less extensive in areas outside of London. The VCTA is in the process of undertaking a research project to gauge awareness of the VCT scheme amongst entrepreneurs and SMEs eligible for VCT investment in regions and nations across the UK. We plan to use our findings to develop a programme of events for raising awareness of the scheme outside of London and the South East.

Lack of awareness is not the only issue – in 2021, the VCTA undertook an analysis of our regional investment activity data with a specific focus on age of business. The VCTA would note that the trends of regional investment being weighted to Greater London have been previously identified in studies carried out by the Department for Business, Energy and Industrial Strategy but these did not specifically consider the impact of age of business and the VCT/EIS age restrictions (these are that a company must receive its first risk finance investment no later than 7 years after its first commercial sale (10 years for knowledge-intensive companies) - except in certain specific circumstances).

Our analysis found that while there is significant variation between regions there is a high differential on age of business when considering Greater London (5.1 years) vs. Rest of UK (7.02 years). Businesses in Greater London receive on average a larger initial investment of £2.38m vs. £2.11m in the Rest of UK. The populations on size, value and age of investment are therefore comparable. It is more challenging for a business based outside of London to qualify under the VCT age restrictions, because it takes those companies longer to get to the stage where they are ready to seek out VCT funding to enable them to continue to grow. The VCTA has previously made some suggestions about how the way the permitted maximum age limit operates could be amended in our most recent Budget submission[6]. However, we also believe it is important to consider policy interventions to help companies in the regions to grow more quickly, which would make it more likely that more businesses outside of Greater London would meet the VCT age restrictions as they stand.

In 2019, the Department for Business, Energy and Industrial Strategy identified the weighting of investment activity towards Greater London, showing a range of criteria as contributing factors:

- Supply side, e.g., London having more venture capital funds, international investors and angel investors, and importantly;
- Demand side, e.g., lower proportion of family company ownership in London, greater experience of taking investment, available talent pools etc.

In the case of the VCTA, our membership comprises longstanding UK based investors with regional investment networks, with investment teams often dedicated to specific regions and who are actively seeking to source and originate investment opportunities. For example, YFM was founded in Wakefield, and supports businesses through offices in Leeds, Manchester, and Birmingham, while Mercia supports businesses across the Midlands.

This all suggests that the blocker to investing further is a company demand side issue and that it is Greater London's talent pools, economic scale and connectivity which is a driver to incubate and mature businesses more quickly, to reach a size and scale to be investible. The data above clearly shows a differential in age of business at point of investment between Greater London and Rest of UK, indicating that those businesses outside of London take longer to mature, particularly those in more traditional industries and those that have been impacted by Covid.

In light of this, the VCTA believes that policy focused on improving the geographical distribution of start-ups would not best be achieved through central policy, and should be focused on empowering local institutions, in conjunction with wider policy efforts to (e.g.) improve connectivity in regions outside of London and the South East. We also believe it is vital that government engages regularly with networks of investors, like VCT funds, which are active across the UK's regions and nations, to get an on-the-ground sense of barriers to investment in start-ups in specific areas.

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[6] VCTA 2021 Budget Submission

6. Should we be encouraging more firms to list in London? If so, how?

– What are the economic benefits, and how great are they, from firms listing in London rather than elsewhere?
– How does the complexity and flexibility of the listings regime compare with other key financial centres?

The VCTA is supportive of encouraging more firms to list in London, recognising the part this has to play in maintaining and building on the capital's role as a global financial centre.

We welcome proposals to ensure London remains one of the most attractive places to grow and list successful innovative companies, and to improve the UK's competitive position.

VCTs typically invest in both small, privately owned companies, and shares of SMEs that are traded on the Alternative Investment Market (AIM). The AIM plays a hugely important role in enabling smaller companies who would struggle to meet the requirements of the Main Market to raise the capital needed to scale. The importance of the AIM should be taken into consideration when designing policies and initiatives to encourage more firms to list in London.

7. How do we ensure that women and people from ethnic minorities can access the finance, support, and networks necessary to successfully start businesses?

– What are the key barriers to women and people from ethnic minorities starting and growing businesses?

It is very important that in the start-up ecosystem – where the most innovative, high potential businesses of the future are being created – women and people from ethnic minorities are properly represented.

At present, we recognise that women and people from ethnic minority backgrounds remain under-represented amongst start-up founders raising venture capital, and this is something we are eager to change.

The VCTA is currently undertaking surveys of our membership and their investee portfolios to establish a clearer sense of how well represented women and people from ethnic minorities are amongst business founders and C-suites, fund managers and on VCT portfolio boards. The results of these surveys will create a baseline against which we can set targets and measure future improvements resulting from initiatives to improve diversity and inclusion, including a VCTA trade body pledge on diversity.

Many of our members are already actively involved in various programmes to increase representation of women and people from ethnic minorities in our industry, including the Investing in Women Code, the Women in Finance Charter, Diversity VC and 10,000 Black Interns. We are planning to collate the initiatives currently in place among VCTA members and use this as a central resource to spread best practice on diversity and inclusion across the VCT industry.

We believe that where government can be most effective in ensuring that women and people from ethnic minorities can access the finance they need to successfully start and grow businesses is by working hand in hand with industry on initiatives designed to create networking opportunities, connections and support networks for women and people from ethnic minorities within the investment ecosystem. Providing the right networking arrangements is hugely important, because connections to the business investment world are often crucial in knowing how best to access start-up finance.

Government and investors like VCTs could also work together effectively on an education piece to raise awareness about the types of start-up funding that are available, and how to apply for them. The aim should be to ensure that all entrepreneurs – and all potential founders of start-up companies – understand that the finance is available regardless of their gender or ethnicity.